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SBA'S SMALL BUSINESS INVESTMENT COMPANIES PROGRAM

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

SBA'S SMALL BUSINESS INVESTMENT COMPANIES PROGRAM

MAY 9, 1990
MAY 16, 1990
JUNE 21, 1990
AUGUST 2, 1990

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SBA'S SMALL BUSINESS INVESTMENT COMPANIES PROGRAM

WEDNESDAY, MAY 9, 1990

U.S. Senate,
Committee on Small Business,
Washington, DC.

The Committee met, pursuant to notice, at 9:36 a.m., in room SR-428A, Russell Senate Office Building, Hon. Dale Bumpers (Chairman of the Committee) presiding.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

The Chairman. This morning the Committee begins a series of investigative and oversight hearings on problems in the SBIC industry. Small Business Investment Companies, since their inception in 1958, have been the chief Federal tool in meeting the lack of equity capital available for small companies. In years past, this Committee has noted with pride some of the amazing successes of SBICs as a major justification for the continued existence of the Small Business Administration.

Today, unhappily, we address the two largest failures in the history of this program, as well as apparent shortcomings in the SBA's management of one of these failed institutions.

The demise of River Capital Co. and Royal Business Funds will eventually cost the Government $40 to $45 million. Our purpose is not only to find what went terribly wrong in these two cases but also to determine if there are systemic problems in administration of the SBIC Program which should be addressed by this Committee in legislation.

I might digress from my prepared statement to say that since 1958, we have had 1,300 licensed SBICs. All of them have gone into liquidation or surrendered their charter except 375, plus perhaps 100 MESBICs, and 170 of those are now in liquidation. The Government's exposure is well over $500 million. As W.C. Fields used to say, "That ain't beanbag."

This is not to say that the Government is going to lose $560-plus million. But it is to say that that is how much these SBICs, which are in liquidation, owe the Government, and I must say if they come out as badly as River Capital did and as badly as the Royal Business firm did, we could very well wind up having to pony-up the $500-plus million.

Based on reports I have seen prepared by the Inspector General's staff, there may have been serious flaws in work performed by the public accounting firm which prepared the 1986 and 1987 audits of River Capital. Troubling as this prospect is, I am also concerned about the performance of both the Investment Division, which manages the SBIC Program, and the IG's office, as well. I note that one of the television networks yesterday aired a report extremely critical of the Inspector General's office. Obviously, River Capital did not lose $35 million solely because of actions taken or not taken by either the IG or its accounting firm, Arthur Andersen.

Further, it is important to note that the Committee is not sitting as the trier of any potential civil liability by Arthur Andersen & Co., based on the IG's findings. If there is any such liability, it will be determined in another forum.

Next week, the Committee will receive testimony from program managers at SBA concerning their post mortem report on these two cases and on the status of the program generally. The Agency has recently procured two consultant studies, which raise very serious issues in the management of this program, especially in the liquidation of failed companies.

Currently, as I pointed out earlier, there are 170 SBICs in liquidation, and they owe the Government over $563 million, and hold investments in over 1,000 small businesses. Yet, the consultant has reported—this entire operation is being managed by six staff persons, with one part-time secretary. Until 1984, there was only one professional staff person assigned to SBIC liquidations. This lack of resources is clearly another example of the impact of starving regulatory agencies to create short-term savings, for which we will always wind up paying an enormous price in the long run.

The number of SBICs going into liquidation is increasing and the amount owed by companies in liquidation has doubled since 1986. The consultant's report says, "If this trend is not reversed quickly, the situation will pass from 'critical' to the 'melt-down' stage."

This morning, we have Inspector General Gillum with us and two of his assistants, who I will ask him to identify then and then to proceed with his testimony.

Good morning, Mr. Gillum.

STATEMENT OF CHARLES R. GILLUM, INSPECTOR GENERAL, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC, ACCOMPANIED BY STEPHEN N. MARICA, ASSISTANT INSPECTOR GENERAL FOR INVESTIGATIONS; AND PETER L. McCLINTOCK, ACTING ASSISTANT INSPECTOR GENERAL FOR AUDITING, SBA

Mr. GILLUM. Good morning, Mr. Chairman.

I am accompanied this morning by Stephen Marica, our Assistant Inspector General for Investigations, and Peter McClintock, our Acting Assistant Inspector General for Auditing.

You may recall that the last time we were here, the Assistant Inspector General for Auditing was Steven Switzer, and I would like just to point out that Steve has been promoted to the Deputy Inspector General's job at the Resolution Trust Corp., and we are going to miss him. Contrary to some of the things that were said on national television yesterday, I would like to point out that——

The CHAIRMAN. I thought he looked pretty nice on that show.

Mr. **Gillum** [continuing]. I think he has had a distinguished career. He is a bright young man. He has done great Government service. He has served his country both in the service, the military service, and through public service, and his treatment yesterday was a little bit appalling.

In the interest of time, I have already provided copies of my statement for the record and would like just briefly to summarize the high points before taking your questions.

I came this morning with some prepared remarks on my office's activities with respect to the SBIC industry, particularly our audits of two former SBICs, known as River Capital Corp., and Royal Business Funds Corp.

Events have overtaken us somewhat, however, as you have mentioned, and as those know who saw the CNN story yesterday afternoon of our alleged "cover-up" of the River Capital failure.

I want to make two points very clear at the outset of this morning's hearing. First, we have not—I would repeat "not"—engaged in any cover-up or failed to do our duty to manage our audits responsibly. GAO was asked to look into my office's handling of the River Capital audit, and concluded that we had acted properly and there was no basis for any cover-up charge at all. This fact was known to the press.

Second, an SBIC that fails and is liquidated owes its fate to its own management and financial problems rather than to any outside audit conducted either by my office or by an independent accounting firm. River Capital's failure was clearly due to its own practices; SBA program managers were aware of these problems and did not need or want our final report before they took action to preserve the Government's interests by placing that company in liquidation. I will address these points more in later detail.

Our SBIC Audit Program must be looked at as just one part of our overall activities over the past 2 years. Our investigations operations have seen outstanding success and progress. While we have made some real headway in our audit operations, we still have a long way to go to deliver a top quality audit program.

Among other things, we need to shift our emphasis away from the SBIC examinations, and there I am talking about doing them on a periodic basis. We need to do less in number, but do more in terms of being thorough. Second, we need to provide a more balanced audit coverage of all the Agency programs. We cannot continue to focus our resources on an area, even though important as the SBIC Program is, we cannot focus on a $1.5 billion exposure while the rest of the Agency's programs and portfolios, which reach into approximately $15 billion, go uncovered.

We also face the challenge of having to operate within limited and even diminishing resources. As an example, we currently have vacancies in 15 percent of our audit staff. This is strictly due to budget constraints because we have the positions; we just don't have the money to pay the salaries.

All of these factors have a bearing on everything we will discuss today.

You have asked for an assessment of the overall financial status of the SBIC industry. While we do not have a broad base of information from our own audits, data from other sources indicates that we should all be concerned. Some key indicators are these. The SBIC Program does involve about a $1.5 billion exposure. Nineteen percent of the 404 operating and special SBICs are rated at above average or higher risk. One hundred seventy SBICs were or are in liquidation. OIG SBIC work has focused on meeting production requirements, meeting semiannual and biennial requirements, and has been limited in scope and lacking in depth. Fourteen SBICs are currently under investigation.

The CHAIRMAN. How many?

Mr. GILLUM. Fourteen.

GAO has criticized the quality of our CPA audits and the way we oversight that work. Our audit of Royal Business Funds raises serious concerns about internal controls and the adequacy of SBA staffing in these two programs. These and other problems were confirmed by a Management Report Study that you just mentioned.

While we have not been able to do a serious industry analysis based upon financial, economic, or other market factors, these indicators that I have mentioned do command our concern.

I have been asked to discuss our review of River Capital, which defaulted on $28.5 million in SBA guaranteed debentures. River Capital's problems stemmed from its accounting practices, which I believe were not appropriately identified and reported in the annual financial audit done by a CPA firm.

Some questions have been raised about my office's handling of this matter. I have provided a detailed chronology of our audit in my formal statement.

Very briefly, the key points are these. SBA placed River Capital in liquidation while we were still in the early stages of our audit field work.

The draft audit report was processed through the many stages of initial writing, supervisory review, coordination with the investment division, discussions with the CPA firm, and necessary revisions, in a fashion that was not as diligent as we would have wanted.

The referral of the substandard CPA work to the AICPA has always been a matter of when, not if. I should digress here to say that this is not to rush to judgment with respect to that work; only that it became the focus of proper review and consideration.

Department of Justice and SBA Office of General Counsel attorneys involved in River Capital's bankruptcy action agreed that we should not issue a final report because the SBIC was already in liquidation, and that we should refer our referral of the CPA matter to the AICPA, that we should not refer it because of the pending litigation.

Let me turn to Royal Business Funds Corp.

SBA placed Royal Business Funds in liquidation in 1982 and formed a corporation known as "EWE" to hold and liquidate its assets. Unlike other SBICs, Royal Business' portfolio consisted of several businesses which it owned, some of which were still in operation. Our audit found that, in our opinion, the creation of EWE was contrary to law. EWE developed a ski resort and a Florida property rather than selling them "as is," which will lose, in our estimation, $11 million to $15 million more than if we had sold them in a timely fashion. EWE's operations resulted in actual or apparent conflicts of interest. EWE did not properly account for all liquidation funds. SBA senior managers were not adequately informed of EWE's existence until very recently, and, therefore, were not able to supervise and oversight and be involved in its operations.

The Administrator has already taken prompt action on many of our 16 recommendations for corrective action, including obtaining two outside management studies of the SBIC Program. These studies are significant management actions that deserve credit.

You asked that we pay some attention to and comment on what possibly caused the collapse of River Capital.

To be truthful, at this time we are not able to draw any conclusions from the collapse of River Capital and Royal Business Funds. Royal Business Funds was put into liquidation 10 years ago, and we have not focused on the reasons for the failure of that because our work has been focused strictly on the liquidation aspects of that company.

River Capital's failure occurred more recently, but was followed by bankruptcy filings. At the moment, its owners and officers may be the only ones who know with certainty what actually caused its failure. While the possibility of fraud is always present, it is most likely that both SBICs failed for the same reasons companies fail every day—lack of capital, bad business decisions, and changing economic conditions. In the absence of other evidence, I hesitate to conjecture about the motives and actions of others.

What can we do and what steps can we take for the future?

In our view, several steps can be taken to insure the future integrity of the SBIC Program. Briefly, key legislative and management changes are needed: Changing from a biennial to a periodic SBIC examination requirement is necessary. Putting in place an effective quality assurance program for non-Federal audit work is a necessity and has been recommended by GAO. Improving our internal audit coverage of major SBIC activities has to be also included. Revising the audit guide for SBICs to conform to GAO audit standards is important. Also are agency adoption of audit resolution and tracking procedures to implement the IG act amendments of 1988 and its reporting requirements; and providing more resources to SBIC Program and liquidation activities.

Many of these initiatives have been implemented or are already underway or under study.

I would be pleased to respond to any questions, Mr. Chairman.

[The prepared statement of Mr. Gillum follows:]

SBA U.S. Small Business Administration Washington DC 20416

STATEMENT OF
CHARLES R. GILLUM
INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. SENATE
MAY 9, 1990

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE:

I AM HERE IN RESPONSE TO YOUR LETTERS OF FEBRUARY 22, AND APRIL 27, 1990, INVITING TESTIMONY ON THE PRESIDENT'S BUDGET PROPOSAL FOR THE SMALL BUSINESS ADMINISTRATION AND CERTAIN ACTIVITIES OF THE OFFICE OF INSPECTOR GENERAL. MY COMMENTS REPRESENT MY VIEWS AND THOSE OF THE OFFICE OF INSPECTOR GENERAL, AND NOT NECESSARILY THOSE OF THE ADMINISTRATION. MY STATEMENT, WHICH HAS BEEN SUBMITTED FOR THE RECORD, HAS NOT BEEN SUBJECT TO COORDINATION WITH OR APPROVAL BY OMB OR THE AGENCY.

THIS STATEMENT SUPPLEMENTS MY PREVIOUSLY SUBMITTED STATEMENT OF MARCH 8, 1990, BY ADDRESSING IN GREATER DETAIL THE RESULTS OF OUR INVESTIGATIONS OF RIVER CAPITAL CORPORATION AND ROYAL BUSINESS FUNDS CORPORATION, COMPANIES FORMERLY LICENSED TO OPERATE AS SMALL BUSINESS INVESTMENT COMPANIES (SBICs) AND OTHER ASPECTS OF THE SBIC PROGRAM OVERALL.

ASSESSMENT OF THE OVERALL STATUS OF THE SBIC INDUSTRY

YOU HAVE ASKED THAT WE PROVIDE AN ASSESSMENT OF THE OVERALL FINANCIAL STATUS OF THE SBIC INDUSTRY. AS I EXPLAINED IN MY STATEMENT OF MARCH 8TH, FOR A NUMBER OF REASONS WE DO NOT HAVE A BROAD BASE OF INFORMATION, BASED ON OUR OWN WORK, FROM WHICH WE CAN ASSESS WITH PRECISION THE BASIC HEALTH OF THE INDUSTRY. THERE IS, HOWEVER, INFORMATION FROM A NUMBER OF SOURCES, (FOR EXAMPLE: MANAGEMENT REPORTS AND STUDIES, AUDITS AND INVESTIGATIONS, OUR CRITERIA BASED SBIC PLANNING PROCESS, AND THE FEDERAL MANAGERS FINANCIAL INTEGRITY ACT DISCLOSURES), WHICH PROVIDE INDICATORS THAT RAISE THE CONCERNS AND INTERESTS OF OUR AUDITORS AND INVESTIGATORS--PERSONNEL WHO BY THEIR NATURE AND TRAINING SHOULD, OF COURSE, BE BOTH SKEPTICAL AND INQUISITIVE. SOME OF THE INDICATORS ARE AS FOLLOWS:

- THE SBIC PROGRAM REPRESENTS AN EXPOSURE OF APPROXIMATELY $1.5 BILLION.
- 19% OF THE 404 OPERATING SBICS AND SPECIAL SBICS ARE CONSIDERED ABOVE AVERAGE OR HIGHER RISK BASED ON REGULATORY AND FINANCIAL CONDITIONS.

- APPROXIMATELY 170 SBICS WERE OR ARE CURRENTLY IN LIQUIDATION.
- THE PRINCIPAL FOCUS OF OIG AUDIT WORK OVER THE PAST SEVERAL YEARS HAS BEEN ON ANNUAL/BIENNIAL LICENSEE EXAMINATIONS WHICH WERE PRODUCTION ORIENTED AND LIMITED IN SCOPE.
- NO SIGNIFICANT INVESTMENT OF INTERNAL AUDIT RESOURCES HAD BEEN MADE OVER RECENT YEARS FOR THE CONDUCT OF INDEPTH PROGRAM AUDITS.
- GAO REPORTED THAT QUALITY ASSURANCE REVIEWS BY CPAs WERE NOT ADEQUATE AND CPAs WERE NOT COMPLYING WITH GAO STANDARDS.
- AS OF MARCH 9TH, 14 SBICS WERE THE TARGETS OF INVESTIGATIONS.
- THE AUDIT OF ROYAL BUSINESS FUNDS CORPORATION PROVIDES ANECDOTAL EVIDENCE OF SIGNIFICANT INTERNAL CONTROL PROBLEMS AND QUESTIONS ABOUT THE ADEQUACY OF AGENCY STAFFING.
- A MANAGEMENT STUDY BY OUTSIDE CONSULTANTS CONFIRMED THE FINDINGS IN THE AUDIT OF ROYAL BUSINESS FUNDS CORPORATION AND HIGHLIGHTED PROBLEMS NEEDING ATTENTION.
- PROBLEMS IN THE FINANCIAL COMMUNITY IN GENERAL AND THE ECONOMIC DOWNTURNS BEING EXPERIENCED IN SUCH PLACES AS TEXAS AND ARIZONA POSE QUESTIONS AS TO THE POSSIBLE IMPACT ON THE SBIC PROGRAM.

I BELIEVE THE CUMULATIVE EFFECT OF THESE FACTORS PROPERLY RAISE THE CONCERNS OF OUR AUDITORS AND INVESTIGATORS, AND MORE THAN JUSTIFY OUR EFFORTS OVER THE LAST COUPLE OF YEARS TO SHIFT THE DIRECTION OF OUR AUDIT PROGRAM. IT IS JUST AS READILY OBVIOUS THAT SUCH FACTORS ARE ABSENT ANY SERIOUS ANALYSIS OF SOPHISTICATED ECONOMIC, FINANCIAL, OR OTHER MARKET CONSIDERATIONS, STRONGLY SUGGESTING CAUTION IN MAKING PREDICTIONS, BUT NECESSITATING ATTENTION AND CONCERN.

RIVER CAPITAL CORPORATION AND ROYAL BUSINESS FUNDS CORPORATION

YOU HAVE ASKED THAT I DISCUSS THE RESULTS OF OUR REVIEWS OF RIVER CAPITAL CORPORATION, A SMALL BUSINESS INVESTMENT COMPANY, WHICH DEFAULTED ON $28.5 MILLION IN SBA GUARANTEED DEBENTURES AND ROYAL BUSINESS FUNDS CORPORATION, ANOTHER SBIC WHICH DEFAULTED ON $18 MILLION IN SBA GUARANTEED DEBENTURES. I WILL ADDRESS RIVER CAPITAL CORPORATION FIRST AND THEN ROYAL BUSINESS FUNDS CORPORATION SECOND.

RIVER CAPITAL CORPORATION

RIVER CAPITAL'S MAJOR PROBLEMS, AS PREVIOUSLY REPORTED IN MY STATEMENT OF MARCH 9TH, WERE RELATED TO DEFICIENCIES IN ITS ACCOUNTING PRACTICES. THESE DEFICIENCIES WERE NOT, IN OUR OPINION, APPROPRIATELY IDENTIFIED AND REPORTED UPON BY THE FIRM THAT PERFORMED RIVER CAPITAL'S ANNUAL FINANCIAL AUDIT. THERE HAS ALSO BEEN ATTENTION AND INTEREST FOCUSED ON HOW THE OFFICE OF

INSPECTOR GENERAL HANDLED THE REPORTING OF THESE DEFICIENCIES DURING OUR LAST AUDIT OF RIVER CAPITAL. THEREFORE, I WOULD LIKE TO SUMMARIZE THE PROCESS FOR THE RECORD.

RIVER CAPITAL DEFAULTED ON ITS SBA GUARANTEED DEBENTURES ON JULY 1, 1988 AND WAS SUBSEQUENTLY NOTIFIED, BY LETTER DATED AUGUST 3RD, OF SBA'S INTENT TO PLACE THEM IN LIQUIDATION. OUR AUDIT SITE WORK WAS INITIATED JULY 25, 1988 AND CONTINUED THROUGH AUGUST. THE AUDITOR, MR. LAPATO, SUBMITTED A DRAFT REPORT TO HIS SUPERVISOR IN NOVEMBER 1988. IN DECEMBER, PETER MCCLINTOCK, EASTERN REGIONAL INSPECTOR GENERAL FOR AUDITING, PROVIDED A COPY OF THE INITIAL DRAFT REPORT TO THE OFFICE OF PORTFOLIO MANAGEMENT (OPM). IN FEBRUARY 1989, WE TRANSMITTED A REVISED DRAFT REPORT TO THE INVESTMENT DIVISION, OPM, AND THE CPA FIRM, WITH A REQUEST FOR COMMENTS. IN MARCH, WE RECEIVED COMMENTS FROM THE INVESTMENT DIVISION, AND MET WITH REPRESENTATIVES OF THE CPA FIRM TO HEAR THEIR COMMENTS ON OUR DRAFT FINDING CONCERNING THE QUALITY OF AUDIT WORK PERFORMED BY THEIR AUDITORS. BASED ON THEIR COMMENTS, MR. LAPATO AND MR. MCCLINTOCK VISITED THEIR OFFICE IN APRIL AND REVIEWED THEIR WORKING PAPERS AGAIN TO MAKE SURE WE TOOK ALL OF THEIR WORK INTO ACCOUNT.

MR. MCCLINTOCK DECIDED THAT THE FINDING NEEDED ADDITIONAL INFORMATION TO SUPPORT OUR CONCLUSIONS ON THE SUBSTANDARD CPA WORK AND REQUESTED MR. LAPATO TO REVISE THE REPORT. THE REVISION TO THE REPORT DID NOT PROVIDE SUFFICIENT ANALYSIS, THEREFORE MR. MCCLINTOCK PROVIDED MR. LAPATO AND HIS SUPERVISOR, MR. TROYAN, ADDITIONAL GUIDANCE AND DIRECTED THEM TO PREPARE A REFERRAL ON THE SUBSTANDARD WORK TO THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), WHICH WAS A PROCESS ENDORSED BY THE U. S. GENERAL ACCOUNTING OFFICE AND THE PRESIDENT'S COUNCIL ON INTEGRITY AND EFFICIENCY (PCIE). AT THAT TIME, MR. LAPATO ANNOUNCED HIS RETIREMENT. PRIOR TO HIS RETIREMENT, WE HAD HIM TRAVEL TO WASHINGTON TO BRIEF ANOTHER AUDITOR ON THE ISSUES. THIS SECOND AUDITOR BEGAN WRITING IN AUGUST.

IN SEPTEMBER, BARBARA WARD, AN ASSISTANT U. S. ATTORNEY, CONTACTED US REGARDING RIVER CAPITAL'S FILING FOR BANKRUPTCY. CONSISTENT WITH DISCUSSIONS BETWEEN MR. MCCLINTOCK AND MS. WARD, ERIC BENDERSON (SBA'S ASSOCIATE GENERAL COUNSEL FOR LITIGATION), AND OTHER SBA ATTORNEYS, WE DECIDED, IN OCTOBER 1989, TO (1) NOT ISSUE AN AUDIT REPORT BECAUSE RIVER CAPITAL WAS ALREADY IN LIQUIDATION THEREBY MAKING THE ISSUANCE OF AN AUDIT REPORT MOOT, AND (2) DOCUMENT THE PROBLEMS WITH THE QUALITY OF THE CPA'S AUDIT WORK IN A SEPARATE MEMORANDUM AND DEFER REFERRING THE SUBSTANDARD WORK TO THE AICPA UNTIL SO ADVISED BY THE ASSISTANT U.S. ATTORNEY. WE ISSUED THE LATTER DOCUMENT ON JANUARY 25, 1990 AND PROVIDED A COPY TO THE SENATE COMMITTEE ON SMALL BUSINESS.

ROYAL BUSINESS FUNDS CORPORATION

BASED ON DISCUSSIONS WITH THE AUDIT STAFF SHORTLY AFTER I ARRIVED AT SBA IN 1987, I BECAME CONCERNED ABOUT SBICS IN LIQUIDATION BECAUSE, UNDER PREVIOUS PROCEDURES, THE OFFICE OF INSPECTOR GENERAL DID NOT CONDUCT AUDITS OF SBICS ONCE THEY ENTERED LIQUIDATION STATUS. THEREFORE, I INITIATED AN INTERNAL AUDIT ON LIQUIDATION ACTIVITIES. DURING THE COURSE OF THIS AUDIT, WE LEARNED ABOUT THE LIQUIDATION OF ROYAL BUSINESS FUNDS CORPORATION (RBFC) THROUGH THE USE OF AN SBA ESTABLISHED CORPORATION, EWE PROPERTIES, LTD. (EWE). AS WE BECAME FAMILIAR WITH EWE AND THE COMPLEXITIES OF THE AUDIT, OUR INTERNAL AUDIT FOCUSED ONLY ON THIS LIQUIDATION. WE ISSUED OUR AUDIT REPORT ON THE LIQUIDATION OF ROYAL BUSINESS FUNDS CORPORATION IN AUGUST 1989.

RBFC WAS PLACED IN LIQUIDATION ON MAY 12, 1982. ON JULY 15, 1982, RBFC WAS PLACED IN RECEIVERSHIP WITH SBA APPOINTED AS RECEIVER BY THE UNITED STATES DISTRICT COURT IN NEW YORK. DURING THE RECEIVERSHIP, THE COURT APPROVED $5,550,000 IN RECEIVER'S CERTIFICATES TO DEVELOP THE CONQUISTADOR SKI AREA IN WESTCLIFFE, COLORADO. THE SKI RESORT REQUIRED THE INFUSION OF ADDITIONAL FUNDS IN ORDER TO: CONSTRUCT ADDITIONAL CHAIRLIFTS, A SNOW-MAKING SYSTEM, ROADS, AND RESERVOIRS; EXPAND AN EXISTING LODGE AND BUILD A NEW ONE; AND COMPLETE OTHER IMPROVEMENTS.

THE RECEIVERSHIP ENDED ON MAY 8, 1984 THROUGH A NEGOTIATED SETTLEMENT BETWEEN RBFC AND SBA. THIS CONSISTED OF A CONSENT JUDGMENT AND ORDER AGAINST RBFC FOR $32,217,365, CONSISTING OF $18,531,703 IN ORIGINAL DEBENTURES AND NOTES, $5,500,000 IN RECEIVER CERTIFICATES AND $8,135,662 IN ACCRUED INTEREST. THE CONSENT JUDGMENT AND ORDER SATISFIED THE JUDGMENT OF DEBT BY RBFC TO SBA BY TRANSFERRING VIRTUALLY ALL OF ITS ASSETS TO SBA ON JULY 31, 1984.

UNLIKE OTHER SBICS WHOSE ASSETS CONSIST PRIMARILY OF LOAN PORTFOLIOS, MOST OF THIS SBIC'S ASSETS WERE WHOLLY OR PARTIALLY OWNED BY RBFC ITSELF AND CONSISTED OF SEVERAL DIVERSIFIED BUSINESSES, SOME STILL IN OPERATION. SBA BELIEVED THAT THE BEST WAY TO MANAGE THE OPERATION AND LIQUIDATION OF THE ASSETS WAS TO FORM A SEPARATE CORPORATION THAT WOULD PROVIDE AN UMBRELLA OF COMMON MANAGEMENT, ACCOUNTING AND SHARING OF PERSONNEL BETWEEN THE VARIOUS BUSINESSES. SBA FORMED A SEPARATE CORPORATION, EWE PROPERTIES, LTD., TO HOLD AND LIQUIDATE THE ASSETS ACQUIRED FROM RBFC.

IN SUMMARY, OUR AUDIT REPORT CONTAINED THE FOLLOWING FIVE FINDINGS:

1. THE CREATION OF EWE IN 1984 WAS CONTRARY TO THE GOVERNMENT CORPORATION CONTROL ACT, WHICH PROHIBITS THE ESTABLISHMENT OF A CORPORATION TO ACT AS AN AGENCY UNLESS SPECIFICALLY AUTHORIZED BY

LAW. EWE GAVE SBA A VEHICLE TO OPERATE THE LIQUIDATION OUTSIDE OF THE TREASURY FISCAL LAWS AND OTHER FEDERAL REGULATIONS RESULTING IN (1) DEPOSITING FUNDS UNTIMELY INTO THE TREASURY , (2) DISBURSING FUNDS WITHOUT OBTAINING TREASURY DEPARTMENT AUTHORITY TO DO SO, (3) AUGMENTING SBA'S SALARY AND EXPENSE APPROPRIATION BY PAYING FOR OFFICIAL TRAVEL WITH EWE FUNDS AND "LENDING" MONEY TO PAY FOR OTHER SBA EXPENSES, AND (4) AWARDING CONTRACTS WITHOUT FOLLOWING ESTABLISHED PROCUREMENT PRACTICES.

2. EWE DEVELOPED TWO MAJOR ASSETS, A SKI RESORT AND A FLORIDA PROPERTY RATHER THAN SELLING THEM "AS IS". WE ESTIMATE THAT THIS DEVELOPMENT EFFORT WILL LOSE BETWEEN $11 TO $15 MILLION MORE THAN WHAT WOULD HAVE BEEN REALIZED HAD THE ASSETS BEEN DISPOSED OF TIMELY AND WITHOUT DEVELOPMENT. SBA HAD SPENT OVER $10 MILLION TO DEVELOP AND OPERATE THE SKI RESORT, ONLY TO HAVE ITS VALUE DECREASE SUBSTANTIALLY. FURTHER LOSSES WILL OCCUR IF THE RESORT IS SOLD FOR LESS THAN THE "AS IS" APPRAISAL VALUE HAD THE PROPERTY BEEN SOLD IN 1983. WHILE THE FLORIDA PROPERTY DEVELOPMENT RESULTED IN NET PROCEEDES OF $3.2 MILLION, SBA MAY HAVE BEEN ABLE TO REALIZE $3.6 MILLION, HAD THE PROPERTY BEEN SOLD PROMPTLY FOR ITS APPRAISED VALUE PRIOR TO DEVELOPMENT.

3. EWE OPERATIONS INCLUDED ACTIONS AND RELATIONSHIPS WHICH CREATED CONFLICTS OF INTEREST OR THE APPEARANCE OF CONFLICTS. FOR EXAMPLE, EWE HIRED: (1) A CONSULTANT WHO WAS AN ACQUAINTANCE OF AN EWE BOARD MEMBER, AND (2) FIVE CONSULTANTS WHO WERE

FORMERLY ASSOCIATED WITH RBFC OR ITS PRESIDENT. ALL OF THESE CONSULTANTS WERE HIRED ON A NONCOMPETITIVE BASIS.

4. EWE DID NOT PROPERLY ACCOUNT FOR ALL LIQUIDATION FUNDS. EWE OPERATED FOR ALMOST TWO YEARS WITHOUT AN ACCOUNTING SYSTEM AND MANY RECORDS AND DOCUMENTS SUPPORTING FINANCIAL TRANSACTIONS WERE MISSING OR NOT KEPT IN AN ORDERLY FASHION. WHILE ACCOUNTING RECORDS WERE RECONSTRUCTED FOR ABOUT A ONE YEAR TIME PERIOD, EWE DID NOT HAVE SUPPORTING RECORDS TO VERIFY THE PROPRIETY OF EXPENDITURES TOTALLING $4.2 MILLION AND DEPOSITS OF $2.8 MILLION. BASED ON OUR INVESTIGATION THAT FOLLOWED THE AUDIT, A FORMER TREASURER OF EWE HAS BEEN CONVICTED OF EMBEZZLING $40,000 DURING THE FIRST YEAR OF EWE'S OPERATION. WE ARE CONTINUING OUR INVESTIGATION.

5. SBA SENIOR MANAGERS WERE NOT ADEQUATELY INFORMED OF EWE'S EXISTENCE UNTIL RECENTLY, THEREFORE THEY DID NOT HAVE THE OPPORTUNITY TO SUPERVISE OR MONITOR ITS OPERATIONS. THE LACK OF EFFECTIVE MONITORING AND SUPERVISION OVER THE LIQUIDATION, IN OUR OPINION, CONTRIBUTED TO THE PROBLEMS POINTED OUT IN OUR REPORT. FURTHERMORE, SBA HAD FEW WRITTEN PROCEDURES TO INVOLVE TOP MANAGEMENT IN THE LIQUIDATION PROCESS.

OUR REPORT CONTAINED 16 RECOMMENDATIONS FOR CORRECTIVE ACTION. THE ADMINISTRATOR HAS TAKEN PROMPT ACTIONS ON MANY OF OUR RECOMMENDATIONS. AMONG THEM, SHE ENGAGED A CONSULTING FIRM TO

CONDUCT TWO STUDIES ON THE MANAGEMENT OF THE SBIC PROGRAM. THE FIRST STUDY FOCUSED ON SBICS IN LIQUIDATION AND WAS CONSISTENT WITH THE FINDINGS IN OUR REPORT ON THE LIQUIDATION OF RBFC. THE SECOND STUDY IS LOOKING AT HOW THE INVESTMENT DIVISION OPERATES AND WHAT MIGHT BE DONE TO MAKE THINGS BETTER. I BELIEVE THESE STUDIES ARE SIGNIFICANT MANAGEMENT ACTIONS THAT DESERVE ATTENTION AND CREDIT.

CAUSES OF THE COLLAPSE OF RIVER CAPITAL CORPORATION AND ROYAL BUSINESS FUNDS CORPORATION.

RIVER CAPITAL CORPORATION AND ROYAL BUSNESS FUNDS CORPORATION ARE IN MANY WAYS VERY DIFFERENT. ROYAL BUSINESS CORPORATION WAS PLACED INTO LIQUIDATION ALMOST TEN YEARS AGO AND MY OFFICE HAS NOT FOCUSED ON THE REASONS FOR ITS FAILURE AS A LICENSEE. IT CAME TO OUR ATTENTION AS THE RESULT OF AN OVERALL REVIEW WE WERE PERFORMING OF THE SBIC LIQUIDATION PROGRAM. WITH ALL THAT WE LEARNED, AND GIVEN THAT AN INVESTIGATION IS STILL ONGOING, IT WOULD NOT BE AN EFFICIENT USE OF SCARCE OIG RESOURCES TO DO A CASE STUDY OF WHY ROYAL BUSINESS FAILED. BY CONTRAST RIVER CAPITAL WAS PLACED INTO LIQUIDATION VERY RECENTLY AND THEN SOON THEREAFTER FILED FOR BANKRUPTCY. IN A REAL SENSE, AT THE MOMENT THE OWNERS AND OPERATORS OF RIVER CAPITAL MAY BE THE ONLY ONES WHO KNOW WITH ANY CERTAINTY WHAT ACTUALLY CAUSED THAT COMPANY TO FAIL. ONE OF THE THINGS WE WOULD LIKE TO DO IS HAVE OUR AUDITORS LOOK AT RIVER CAPITAL'S PORTFOLIO COMPANIES TO SEE IF WE

CAN DETERMINE WHERE THE MONEY WENT. WE HAVE OFFERED TO DO THIS BUT WE ARE HOLDING ANY SUCH ACTIONS IN ABEYANCE PENDING DECISIONS REGARDING THE NEED OR ABILITY TO SUSTAIN LITIGATION BY THE GOVERNMENT. ALSO, IT IS MY UNDERSTANDING THAT ALLEGATIONS HAVE BEEN MADE TO THE FBI, INCLUDING A SUPPOSED COVERUP BY MY OFFICE, AND ONCE THESE ARE CLEARED UP WE WILL CONSULT WITH THE ATTORNEYS FOR THE AGENCY AND THE UNITED STATES ATTORNEY'S OFFICE, AS TO A COURSE OF ACTION WHICH IS IN THE BEST INTERESTS OF THE GOVERNMENT.

RIVER CAPITAL AND ROYAL BUSINESS FUNDS CORPORATION, WHILE GOING INTO LIQUIDATION ALMOST TEN YEARS APART, WERE TWO OF THE LARGEST SBICS TO FAIL. THEY WERE ALSO TWO OF APPROXIMATELY 170, OR MORE, SBICS THAT HAVE GONE INTO LIQUIDATION OVER THE YEARS WHICH SUGGEST THAT WHILE THERE IS AN INTEREST IN THE POSSIBILTY OF FRAUD EVER PRESENT, THE ULTIMATE ANSWER MAY SIMPLY BE THAT THEY FAILED FOR THE SAME REASONS COMPANIES FAIL EVERY DAY: LACK OF CAPITAL, BAD BUSINESS DECISIONS, CHANGING ECONOMIC CONDITIONS, ETC.

STEPS NEEDED TO ENSURE FUTURE PROGRAM INTEGRITY

YOU ASKED FOR OUR VIEWS ON WHAT MIGHT BE DONE IN THE FORM OF PROGRAM MANAGEMENT OR IN LEGISLATION TO ENSURE THE FUTURE INTEGRITY OF THE SBIC PROGRAM. THESE MATTERS ARE VERY IMPORTANT TO US AND EVEN THOUGH I MADE AN ATTEMPT TO COVER THIS IN MY

STATEMENT OF MARCH 9TH, I APPRECIATE THE OPPORTUNITY TO ADDRESS THOSE CHANGES WHICH WE BELIEVE ARE NEEDED OR ARE IN THE PROCESS OF BEING IMPLEMENTED:

- RELIEF FROM THE STATUTORY REQUIREMENT FOR BIENNIAL EXAMINATIONS OF SBICs, TO ALLOW FOR A MORE FLEXIBLE AND REASONED APPROACH TO THIS, AS WELL AS OTHER ALL AUDIT WORK. WE HAVE CONSISTENTLY PROPOSED THAT SECTION 687(B) OF THE SMALL BUSINESS ACT BE CHANGED TO "PERIODIC EXAMINATIONS IN ACCORDANCE WITH THE INSPECTOR GENERAL ACT."
- FULLY IMPLEMENTING AN EFFECTIVE QUALITY ASSURANCE PROGRAM FOR NONFEDERAL AUDIT WORK, AS REQUIRED BY STATUTE AND RECOMMENDATIONS OF THE GAO.
- IMPROVING THE INTERNAL AUDIT COVERAGE AND QUALITY OF MAJOR PROGRAM AND SUPPORT ACTIVITIES.
- AGENCY ADOPTION OF AUDIT TRACKING AND RESOLUTION PROCEDURES TO IMPLEMENT THE REQUIREMENTS OF THE IG ACT AMENDMENTS OF 1988.
- REVISION OF THE AUDIT GUIDE FOR SBICs (13 CFR 107,APPENDIX 1) TO CONFORM TO GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS, AS REQUIRED AND RECOMMENDED BY GAO.
- ASSESSING THE NEED FOR AND COMMITTING REQUIRED RESOURCES TO THE MONITORING AND MANGEMENT OF BOTH SBIC DELIVERY AND LIQUIDATION ACTIVITIES.

A NUMBER OF THESE ACTIONS HAVE BEEN OR ARE BEING IMPLEMENTED, CONSISTENT WITH FUNDING AND RESOURCE AVAILABILITY. AS PREVIOUSLY MENTIONED IN MY MARCH 9TH STATEMENT, THE ADMINISTRATOR HAS INITIATED TWO VERY NOTEWORTH STUDIES OF THE SBIC LIQUIDATION ACTIVITIES AND THE INVESTMENT DIVISION OF THE OFFICE OF FINANCE AND INVESTMENT, WHICH MANAGES THE SBIC PROGRAM. IT IS MY UNDERSTANDING THAT SOME IMPORTANT CHANGES, INCLUDING A COMMITMENT TO INCREASE STAFFING IN CERTAIN AREAS, HAVE BEEN IMPLEMENTED OR ARE UNDER WAY.

I APPRECIATE THE OPPORTUNITY TO HAVE PRESENTED THE VIEWS OF THE OFFICE OF INSPECTOR GENERAL ON MATTERS OF INTEREST TO THE COMMITTEE.

RESPONSES TO QUESTIONS OF THE U.S. SENATE SMALL BUSINESS COMMITTEE FOR INSPECTOR GENERAL CHARLES R. GILLUM

Question 1. What is the standard practice of your office with respect to review of draft audit reports by SBIC's and others within the agency?

Answer. It is our standard practice to provide audited entities, affected program offices/officials and other parties, as may be deemed appropriate or necessary, with copies of draft OIG audit reports for comment. This practice is in keeping with the Government Auditing Standards of the United States General Accounting Office, which provide, in part, that:

> **The report should include the pertinent views of responsible officials of the organization, program, activity, or function audited concerning the auditor's findings, conclusions, and recommendations, and what corrective action is planned.** (Numbered paragraph 43) (Emphasis in original)
>
> One of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible auditee officials, and others as may be appropriate. Including the views of responsible officials produces a report that shows not only what was found and what the auditors think about it, but also what the responsible persons think about it and what they plan to do about it. (Numbered paragraph 44)

As recently as February 1990, in response to concerns raised by program managers, we adopted procedures to deal specifically with obtaining written comments when auditing Small Business Investment Companies (SBICs). These procedures are set forth in our Staff Memorandum No. 90-GA-2, dated February 6, 1990 (copy enclosed), the operative portion of which is as follows:

> o Written Comments of the Licensee. In those cases where written comments are deemed appropriate, the licensee will be provided a draft of the findings only, without related conclusions and recommendations. When the licensee's comments are received they will be evaluated in terms of their accuracy in relation to the facts of the finding and any discussion of circumstances the licensee believes are pertinent to their position.

In those instances where substandard work of an independent auditor is at issue, the President's Council on Integrity and Efficiency (PCIE) has established guidelines for Inspectors General. These guidelines, PCIE Standards Subcommittee Position Statement No. 4, dated December 5, 1988, provide procedures for making referrals to state boards of accountancy and the American Institute of Certified Public Accountants. Included are provisions for corresponding with, and obtaining the written comments of, the auditor whose work has been questioned.

Question 2. Inspector General, please explain your use of the term "receivers certificates" and their meaning in the context of the Royal Business Funds liquidation.

Answer. Black's Law Dictionary (Fifth Edition, 1979) defines a receiver's certificate as a nonnegotiable evidence of debt, or debenture, issued by authority of a chancery court, as a first lien upon the property of a debtor corporation in the hands of a receiver, and that is the meaning the term was meant to have when it was used in the Royal Business Funds Corporation (RBFC) audit report. The court-approved certificates were issued by the RBFC receiver to evidence the debt created by the additional $5.55 million infusion into RBFC by SBA.

Question 3. Inspector General, bank examiners, under the Comptroller of the Currency, review all of an institution's operations--not just those loans that have gone sour--including whether management has established a system to ensure that it is informed about all significant problems. Would you recommend that your office be given authority in the conduct of SBIC audits which is more analogous to that of bank examiners? Would such a change require legislation?

Answer. These are basically the very things we have been trying to do. The fact is they are not popular with the industry or those who manage the programs. I believe the Inspector General Act of 1978 provides authority to do everything that is mentioned in the question, and possibly more. In fact, beginning in fiscal 1989, or shortly before, efforts were begun to perform reviews of SBICs in accordance with Government Auditing Standards. These efforts had a somewhat rocky start because many of the reviews are broader in scope and more staff intensive than was typically true in the past. They are now smoothing out. What has been at issue are (1) control over resources to do the work and still provide coverage to other agency programs of equal or higher priority (e.g., the 8(a) Minority Small Business Program; loan programs; liquidation activities; procurement; grants management; finance and accounting; etc.) and (2) overcoming bureaucratic resistance to auditors preparing reports which contain conclusions, opinions, and recommendations, as required by Government Auditing Standards. This was not done in the past and is viewed as an intrusion and possible disruption of regulatory authority.

The Inspector General Act of 1978 provides authority for the

Inspector General to appoint an Assistant Inspector General for Auditing to supervise the performance of audit activities relating to the programs and operations of the establishment. According to law, each Inspector General shall:

- o provide policy direction for and to conduct, supervise, and coordinate audits and investigations;
- o comply with the standards of the Comptroller General of the United States;
- o establish guidelines for determining when it shall be appropriate to use non-Federal auditors;
- o assure that any work of non-Federal auditors complies with the standards of the Comptroller General;
- o have access to all records, reports, reviews, papers, or material relating to the programs and operations available to the agency;
- o have authority to request information from any Federal, State, or local governmental agency; and
- o issue subpoenas for the production of records.

If the examiners of the Comptroller of the Currency have authorities in addition to those above which might be useful in getting the job done better and quicker, they would be welcome.

On the subject of legislation, we have consistently proposed in every appropriate forum that we need relief from the present statutory biennial examination requirement. If resources were not critical and other high risk programs of the agency were covered, fixed cycles for examinations would not be at issue. The reality is that resources are critical, there are other high risk programs, and having fixed cycles places us at odds in complying with Inspector General Act and GAO requirements which place a premium on directing resources according to priorities and risks. In addition, it might also be useful to clarify by statute what GAO has already recommended: CPAs and Independent Public Accountants performing audits of government guaranteed loan programs are required to follow Government Auditing Standards.

Question 4a. Inspector General, in the case of Royal Business Funds, how much money was expended by EWE Corp., the liquidator established by SBA personnel, out of liquidation proceeds? In your view, have these expenditures been prudent?

Answer. Our audit identified that EWE expended $8,665,748 between August 1, 1984 and April 30, 1988. In addition, EWE deposited

$5,015,000 in the U. S. Treasury. These figures, however, were based on inadequate accounting records and may not reflect an accurate picture. In our current investigation, we are reviewing these figures but that analysis is not complete. The accounting records were inadequate because they did not incorporate expenditures of the "subsidiary" companies such as Westcliffe Land Corporation (holding company for the Conquistador ski resort) or were otherwise incomplete, and documentation to support expenditures such as cancelled checks and invoices was incomplete and those on hand were not kept in an orderly manner.

Based on our premise that the assets of RBFC should have been sold promptly rather than being developed, most of the expenditures were not prudent. Our report identified some expenditures that were improper (a $200,000 advance to another SBIC in liquidation that was repaid several days later, $10,542 to pay real estate taxes on 2 properties in liquidation not related to RBFC, and $928 to pay for SBA employees' official travel).

In addition, because EWE and its "subsidiaries" did not use established procurement methods, including competition, it is difficult to conclude one way or another, whether any expenditures were reasonable and prudent. Many of the expenditures were authorized by non-government employees and the basis for the expenditure was not known. Some examples of possible imprudent expenditures are: $105,737 for realtor fees that were paid to "market" the Westcliffe property but did not result in a sale; $165,000 (based on a flat monthly fee of $5,500) paid to one of the non-SBA Board members for unspecified legal services; $22,973 for unspecified real estate consulting services; $262,719 paid to various attorneys and $105,528 paid to an accountant without the benefit of written contracts between EWE and the attorneys and the accountant; $361,494 paid to lease vacant property in Florida since the inception of EWE; and $94,000 paid to purchase a fire truck for the Wet Mountain Fire District in Westcliffe, Colorado.

Question 4b. Can you estimate by how much the government's net proceeds from the liquidation have been reduced, or increased, by the liquidator's expenditures, which I gather are paid out of liquidation proceeds?

Answer. It is very difficult to estimate this amount due to the poor recordkeeping practices of EWE. The major operation of EWE was the ski resort which has resulted in SBA investing over $10,000,000 to further develop and operate the property. At this point, it appears that the value of the property has decreased between 1982 and the present time despite SBA's investment, therefore the liquidation proceeds have been reduced by at least $10,000,000.

Question 4c. You stated in your testimony that Royal Business Funds will ultimately lose $11-15 million more than if the assets had been sold in a timely fashion and without further expenditures by SBA. Would you explain the basis for this estimate?

Answer. Appendix 1 of our audit report on the Liquidation of Royal Business Funds Corporation contains a detailed explanation of our estimates. We are summarizing our estimate, but you may want to refer to the detailed explanation in our report.

This estimate is based on comparing estimated proceeds from the liquidation of two properties: the Conquistador ski resort (also known as Westcliffe Land Company) and a Florida property in Deerfield Beach, based on (1) the amounts that may have been received through "as is" sales at or near the time of establishment of the receivership, with (2) the amounts that may result from the "development" of the two properties.

The Deerfield Beach property development resulted in receipts of $5,061,000 and expenses of $1,864,000, for net income of $3,197,000. To determine whether EWE's development efforts were advantageous to the government, we compared the $3,197,000 of net income with an estimate of the amounts that may have been realized if the property had been sold "as is". EWE files contained several appraisals and estimates of the fair market value for the undeveloped property that ranged from $2,400,000 to $3,672,361. If the undeveloped property had sold for $2,400,000, EWE's development efforts were advantageous (+$797,000). However, had the property been sold undeveloped for $3,672,000 (the highest estimated value), the development effort was not advantageous (-$475,361).

The Westcliffe property had two appraisals that we used to establish an estimated "as is" fair market value. The lower appraisal was $5,572,500 (a 1975 appraised value) and the higher appraisal was $12,500,000 which took into account investment by SBA of $4,177,689 up to the appraisal date of June 1, 1983. If the property had been sold "as is" for the lower amount, EWE would not have had to invest $10,315,079 for development, thus saving this amount. We adjusted the estimated $10,315,079 "loss" by another $2,322,500, which was the difference between the "as is" estimate of $5,572,500 and the estimated sales price in December 1988 of $3,250,000, to obtain an estimated loss of $12,637,579.

Had the property sold for the higher amount, adjusted for investment through that time, the total estimated loss would have been $15,387,390. By adding the lower loss figure for Westcliffe (-$12,637,579) to the additional revenue figure for Deerfield Beach (+$797,000), we estimate the "development" loss at $11 million. By adding the two larger "loss" figures, we estimate the "loss" at $15 million.

Question 5. Although this question should perhaps be put to the managers of the Royal liquidation, I am curious what defense they and others in the agency offered of the course of action chosen in setting up EWE Corp. It seems to me that pleading lack of resources, while certainly true, is a little like the defense proffered in the Iran-Contra scam: that it had to be done.

Answer. The responses to our audit report, as well as a legal opinion issued by the Associate General Counsel to SBA's Acting Comptroller offer the authority and "justification" to form EWE. Basically, the Associate General Counsel believed the Small Business Act allows the Agency to "take any and all actions" in liquidating properties, and that the complexities of this liquidation justified the establishment of EWE as an administrative expediency.

We have enclosed a copy of the legal opinion provided to the Acting Comptroller, dated March 25, 1987. Also, please refer to pages 57 through 63, and pages 88 through 105 of our report for the detailed explanation provided on the authority and reasons for establishing EWE, and pages 14 through 21 for our summary of the explanation and our analysis of it. Because of differences of opinion, the Department of Justice has been requested to rule on the matter.

Question 6. Do you know whether RBFC violated any SBA regulations by the manner in which they had structured their investments? I am referring to your statement that Royal evidently owned a number of businesses directly, including the ski resort, rather than holding equity investments in other small firms.

Answer. Our audit did not include any pre-liquidation activities and therefore we cannot answer this question with any certainty. Control of portfolio companies is discouraged by SBA regulations but is allowed on a temporary basis for an SBIC to protect its investments. We have seen references in SBA's liquidation documents that the ownership and control of Royal's investment companies was apparently allowed for this reason.

Question 7. What controls exist for companies in liquidation? In other words, are these companies audited by your office, or is the Office of Portfolio Management audited by your office? Does the General Accounting Office perform any audit function with respect to this agency function?

Answer. There are a number of controls which are applicable to the liquidation program: agency Standard Operating Procedures; Federal procurement rules; Federal personnel management rules; budgeting and accounting requirements; court-appointed receiverships, etc. The program is also subject to audit by both my office and GAO.

In our case, the historical problem has been that resources were committed to the licensee examination aspects of the program. This was done to the point where internal auditing was seriously constrained, if not actually impaired, and this is what we have been trying to turn around. The audit of Royal Business Funds Corporation and related activities represents the most significant effort in this area to date, and justifies a need for additional audit coverage for this program.

Question 8. Inspector General, were you or your staff advised by the United States Attorney's office not to complete an audit report on River Capital? If so, what was their reasoning?

Answer. Both Barbara Ward, Assistant United States Attorney (AUSA), and Eric Benderson, SBA's Associate General Counsel for Litigation, discussed the issuance of the audit report in telephone conversations with Peter McClintock of my office. Both attorneys were concerned that our report (1) may have contained information or conclusions that would jeopardize possible litigation against the Certified Public Accounting (CPA) firm that audited River Capital Corporation's financial statements, or (2) the absence of a finding on the CPA's work could be construed as acceptance of the adequacy of the CPA's work.

Mr. Benderson telephoned Mr. McClintock to discuss the possibility of not issuing a final report and reasoned that a final report was not necessary because River Capital Corporation was already in liquidation. Our audit reports are addressed to the Investment Division who either directs the licensee to correct the regulatory violations or takes actions to protect the Governments interests. In the case of River Capital Corporation, the Investment Division had already placed the licensee in liquidation status. On that basis, Mr. Benderson indicated that he saw no need for a final report.

Mr. McClintock also discussed the issuance of a final report with Ms. Ward, and the possibility of referring the CPA firm's substandard work to the AICPA. Ms. Ward expressed her desire to not have a final report issued and advised Mr. McClintock not to refer substandard work to the AICPA until she had an opportunity to review the case and discuss it further with the SBA attorneys and with Mr. McClintock.

Mr. McClintock advised both Steven Switzer and me of his discussions with Mr. Benderson and Ms. Ward. We agreed with their recommendation not to issue a final report and that we would issue an internal memorandum to Mr. Benderson on the CPA's work.

Question 9. Mr. Gillum, you mentioned allegations of a "cover-up" by your office in the River Capital case which were made by a former employee. This line was also the implication of the television report. Was your handling of this case reviewed by any outside agency, such as the General Accounting Office or the FBI? What were the results?

Answer. As recently as October 1989, I was advised by GAO that a complaint had been received with respect to our handling of a review of a Small Business Investment Company (SBIC). I inquired as to whether the complaint was about River Capital Corporation because I was aware that John Lapato, a former auditor with our office, was unhappy about the handling of the River Capital Corporation audit. I explained this briefly to the GAO auditor, (either Vernon Davis or Rex Simmons), and offered the full cooperation of this office.

Mr. Davis and Mr. Simmons reviewed our files, interviewed Steven Switzer, the then Assistant Inspector General for Auditing; and Peter McClintock, the then Regional Inspector General for Eastern Operations and now Acting Assistant Inspector General for Auditing; Richard Troyan, Assistant Regional Inspector General for Eastern Operations; and possibly others. I was advised orally that while the timeliness of the processing could be improved and the original draft report left a lot to be desired, they had concluded from the available information that there had been no "cover-up".

It is my understanding that the same allegations were made to the FBI several months ago and that they have the allegations under consideration. We have advised the FBI, as we did with the GAO, of our interest in cooperating and assisting that office in any way possible in bringing the "cover-up" allegations to prompt resolution so that we may concentrate our efforts and energies on speculations with respect to fraud.

Question 10. Inspector General, based on your statement that some 19% of existing SBIC's represent higher than average risks in terms of their portfolio of investments, do you have an opinion as to whether perhaps the Investment Division should be more aggressive in placing these companies in liquidation in order to recoup as much as possible for the government.

Answer. While I have no hard data available which would suggest that the Investment Division needs to be either more or less aggressive in placing companies in liquidation, the existence of approximately 170 companies in liquidation would not suggest a lack of aggressiveness. A decision to place a company in liquidation is one of the most serious actions that can be imposed by SBA and in some instances may not be the best solution. There may be instances where a company is capitally impaired or there are regulatory violations of such severity that liquidation may be the only answer. In others, it may require balancing less clear-cut considerations, such as the interests of any viable portfolio companies, workout agreements, infusion of capital, changes of ownership/management, along with the need to protect the Governments interests, etc., in arriving at solutions short of liquidation which may further the overall objectives of the program. These are obviously difficult and demanding decisions for those who manage the program.

Question 11. How many auditors did the OIG have in 1981?

Answer. At the end of FY 1981 we had 62 auditors on-board. This compares to the 50 auditors we had on-board at the end of the first half of FY 1990. The chart below provides additional detail comparing our staffing in FY 1981 and FY 1990 (as of March 31) with respect to our permanent positions.

	FY 1981	FY 1990
OIG Authorized Ceiling	**144**	**131**
Authorized Audit Staff		
Professional	67	57
Support	14	10
Total	**81**	**67**
On-board Audit Staff		
Professional	62	50
Support	11	7
Total	**73**	**57**

The CHAIRMAN. Mr. Gillum, thank you very much.

I have been joined by my distinguished ranking member, Senator Boschwitz.

Do you have an opening statement, Senator Boschwitz?

Senator BOSCHWITZ. I do have an opening statement, Mr. Chairman. It outlines the background of the SBIC Program, the amounts of money that are in it, the amounts of money that are possibly going to be lost or that have been lost over a period of years.

I think I will ask Mr. Gillum some questions about those numbers, and I would ask that the entirety of my statement be put into the record.

The CHAIRMAN. Without objection, your statement will be inserted into the record.

[The prepared statement of Senator Boschwitz follows:]

STATEMENT OF SENATOR RUDY BOSCHWITZ
HEARING ON THE
SMALL BUSINESS INVESTMENT COMPANY PROGRAM
SMALL BUSINESS COMMITTEE
MAY 9, 1990

THANK YOU, MR. CHAIRMAN, FOR HOLDING THIS HEARING WHICH IS THE THIRD IN A SERIES TO REAUTHORIZE THE PROGRAMS AT THE SMALL BUSINESS ADMINISTRATION (SBA). TODAY'S HEARING FOCUSES ON THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM.

SMALL BUSINESS INVESTMENT COMPANIES ARE PRIVATELY OWNED VENTURE CAPITAL FIRMS THAT ARE LICENSED BY THE SBA. AN SBIC MUST HAVE AT LEAST $1 MILLION OF ITS OWN CAPITAL IN ORDER TO APPLY TO BE LICENSED. ONCE AN SBIC HAS INVESTED AT LEAST 65% OF ITS START-UP CAPITAL AND HAS BEEN INVESTIGATED BY THE SBA INSPECTOR GENERAL, IT MAY APPLY FOR LEVERAGE LOANS FROM THE SBA IN AN AMOUNT EQUAL TO THE PRIVATE CAPITAL. THESE MATCHING FUNDS ARE RAISED THROUGH THE SALE OF GUARANTEED DEBENTURES. AFTER THE SBIC HAS INVESTED AT LEAST 65% OF THE COMBINED PRIVATE CAPITAL AND GUARANTEED DEBENTURE FUNDS, IT MAY NOW APPLY TO THE SBA FOR A TWO-TO-ONE MATCH. THIS MAY CONTINUE UNTIL AN SBIC HAS REACHED A THREE-TO-ONE MATCH.

ONCE AN SBIC IS AT THE THREE-TO-ONE MATCH, IT MAY APPLY TO BECOME A VENTURE CAPITAL SBIC. IF IT MEETS THE SPECIFIED CRITERIA IN

THE SMALL BUSINESS ACT, IT MAY BE ELIGIBLE FOR A FOUR-TO-ONE MATCH.

SBIC LOANS ARE FOR 20 YEARS AND AT INTEREST RATES TIED TO THE TREASURY RATE. THE AMOUNT LOANED BY AN SBIC TO ANY ONE BUSINESS MAY NOT EXCEED 20% OF THE PRIVATE CAPITAL INVESTMENT BY THE OWNERS OF THE SBIC (I.E., $1 MILLION PRIVATE INVESTMENT -- $200,000 MAXIMUM LOAN TO ANY ONE SMALL BUSINESS). FOR A BUSINESS TO BE ELIGIBLE TO RECEIVE SBIC FUNDS, IT MUST BE A FOR-PROFIT CORPORATION, PARTNERSHIP OR PROPRIETORSHIP. THE BUSINESS' NET WORTH MUST NOT EXCEED $6 MILLION; AND THE AVERAGE NET PROFIT AFTER TAXES MUST NOT EXCEED $2 MILLION FOR THE LAST TWO YEARS.

IN FY90 $283 MILLION WAS AUTHORIZED FOR THE SBIC PROGRAM, AND $299 MILLION WAS APPROPRIATED. AT THE END OF FY89 THERE WERE 405 SBICS WITH A TOTAL OF $1,884,700,000 IN PRIVATE CAPITAL; THE OUTSTANDING DEBENTURES FOR THE END OF FY89 TOTALED $1,218,600,000.

ALTHOUGH THE ACTUAL LOSS RATE FOR THE SBIC PROGRAM IN FY89 WAS ONLY 1.74%, THE ULTIMATE LOSS RATE WAS 13.9%. THE ACTUAL LOSS RATE INCLUDES THE TOTAL VALUE OF ALL LOANS CHARGED-OFF, ADJUSTED FOR RECOVERIES SINCE THE INCEPTION OF THE PROGRAM, AND THEN COMPARED TO THE TOTAL VALUE OF LOANS DISBURSED SINCE THE INCEPTION OF THE PROGRAM. TO FIGURE THE ULTIMATE LOSS RATE, ESTIMATED FUTURE LOSSES ARE FACTORED INTO THE ACTUAL LOSS RATE CALCULATION. I AM CONCERNED ABOUT THIS HIGH ULTIMATE LOSS RATE.

MR. CHAIRMAN, I AM ALSO CONCERNED ABOUT THE LARGE NUMBERS OF SBICS CURRENTLY IN LIQUIDATION. RIGHT NOW THERE ARE APPROXIMATELY 170 IN LIQUIDATION STATUS WHICH COULD PLACE SBA IN A WORST-CASE POSITION OF LOSING AS MUCH AS $500 MILLION.

THERE IS PARTICULAR EMPHASIS TODAY ON TWO SBICS -- RIVER CAPITAL CORPORATION AND ROYAL BUSINESS FUNDS CORPORATION. RIVER CAPITAL CORPORATION DEFAULTED ON $28.5 MILLION IN SBA GUARANTEED DEBENTURES. OVERDUE INTEREST WAS NOT WRITTEN OFF, AND VALUES FOR RIVER CAPITAL'S INVESTMENTS WERE INFLATED.

THE OTHER SBIC, ROYAL BUSINESS FUNDS CORPORATION (RBFC), HAS A QUESTIONABLE CONNECTION TO EWE PROPERTIES LTD. (EWE). EWE WAS ESTABLISHED FOR THE PURPOSE OF LIQUIDATING RBFC'S ASSETS. EWE IS OWNED BY THREE SBA EMPLOYEES.

FOR A BUSINESS TO BE FORMED TO ACT FOR AN AGENCY (IN THIS CASE, SBA), IT MUST RECEIVE SPECIFIC CONGRESSIONAL AUTHORIZATION. SINCE EWE DID NOT OBTAIN THAT AUTHORIZATION, THE IG HAS DETERMINED THAT EWE IS AN UNAUTHORIZED GOVERNMENT CORPORATION CONDUCTING SBA FUNCTIONS IMPROPERLY. IT HAS ALSO DETERMINED THAT EWE RELATIONSHIPS WITH SBA OFFICIALS AND HIRED CONSULTANTS FORMERLY ASSOCIATED WITH RBFC OR ITS PRESIDENT CREATED THE APPEARANCE OF CONFLICTS OF INTEREST. IN ADDITION, EWE MAY HAVE COST SBA OVER $11 MILLION; EWE DID NOT KEEP ADEQUATE RECORDS; AND SBA MANAGEMENT DID NOT PROPERLY MONITOR THE LIQUIDATION OF RBFC.

ALSO OF INTEREST, IS THE FACT THAT EWE DEVELOPED A SKI RESORT AND A FLORIDA PROPERTY, WHICH WERE IN RBFC'S PORTFOLIO, RATHER THAN SELLING THEM "AS IS." IN BOTH CASES, SBA FUNDS WERE USED FOR THE DEVELOPMENT. SUBSEQUENTLY, THE VALUE OF THE SKI RESORT HAS DECREASED AND THE PROPERTY REMAINS UNSOLD. FURTHER LOSSES TO SBA WILL OCCUR IF THE PROPERTY IS SOLD AT LESS THAN THE "AS IS" APPRAISAL VALUE.

THE FLORIDA PROPERTY WAS ASSESSED AT $3.67 MILLION PRIOR TO ITS DEVELOPMENT. MILLIONS OF DOLLARS WERE SPENT ON THE DEVELOPMENT AND AFTER THE PROPERTIES WERE SOLD THE NET PROFIT WAS ONLY $3.2 MILLION. IT APPEARS SBA RECEIVED LESS MONEY THROUGH DEVELOPMENT THAN THROUGH AN "AS IS" SALE.

I WELCOME INSPECTOR GENERAL CHARLES GILLUM HERE THIS MORNING. I AM VERY INTERESTED TO HEAR WHAT HE HAS TO SAY ABOUT THE SBIC PROGRAM IN GENERAL, AND THESE TWO SBIC'S IN PARTICULAR.

THANK YOU, MR. CHAIRMAN.

The **Chairman**. Let me just begin, Mr. Gillum, by making some general observations.

I have spent a lot of time reading the GAO report; reading your reports as far as these two corporations that failed are concerned; the apparent illegality of EWE; the number of SBICs that have gone into liquidation out of the total; the number of SBICs that are presently in liquidation; the number of SBICs, in addition to that, that are problems right now and, as you say, that probably represent a higher risk than normal. I would start off by saying that it leads me to the conclusion that a number of things—this is an oversight hearing, to decide what action, if any, this Committee and the Congress ought to take.

No. 1, the way we audit these firms is going to have to be severely altered. These audits, as the Arthur Andersen audit of River Capital shows, are utterly worthless to this Committee and to the Congress. And I think it is utterly worthless to the Small Business Administration.

Here you have a corporation, River Capital Corp. Arthur Andersen does an audit on them in the fall, December, I guess, of 1987. Arthur Andersen, incidentally, will be the subject of an additional hearing here, or at least a part of a hearing. But they do an audit in December 1987, showing River Capital to have a value of something like $28 million to $35 million, and they state in the audit that they valued the roughly 40 companies that River Capital had invested in according to what the board of directors said those companies were worth.

It seems apparent, just to a country lawyer, in looking that over that that was an absurdity on its face. Here are millions of dollars of accrued interest which are delinquent, way delinquent. While Arthur Andersen points out that some of this interest is delinquent, they seem to sort of pass over that and say the company intends to take maybe preferred stock in exchange for this interest.

One company is selling for 2 cents a share on the Over-the-Counter Market, and Arthur Andersen never looked behind that.

I'm not condemning them and I'm not saying they didn't follow the generally accepted accounting rules. All I am saying is that we have a $½ billion loss staring us in the face, and to continue doing business as usual is also an absurdity.

Now, for openers, I am going to suggest to the Small Business Administration, and probably, if that does not get the job done, do something stronger than that, that the licensing procedure be suspended, that we not license any more SBICs until we have some better laws or regulations in place to make sure that these companies are operating in some reasonable degree of the law and efficiency.

Now, one of the things that really troubles me is not just the $1.5 billion that we have loaned to all of these SBICs which still exist, but we have 375, of which I believe you say 23 or 27 are now problems.

So the question comes to my mind, based on the kinds of audits we have been getting, what is the condition of the other 350?

In my opinion, we don't know. We are not getting enough out of these audits. You don't have the staff to do it.

What I think we need to do on a rather crash basis, Senator Boschwitz, is to insist maybe on independent audits. It will cost a lot of money, but it might save us a lot of money in the long run. Maybe we ought to have independent audits of all of those remaining SBICs and go behind the documentation. Don't just sit in the board room while the board members, as Senator Hollings says Congress does, gives itself a "good Government award" and goes home. Sit in a board meeting where board members are sitting around saying well, this company is worth this amount, this company is worth this amount, and this company is worth this amount, yet very few of them even had a marketable security, and almost every one of them was showing losses, increasing losses.

I read through that IG Report last night on all the companies that River Capital was invested in. I must say that I am not here to lambast any of these CPA firms or the consultants who do this. But, as I said, as I looked through that and I looked over the numbers of those companies that River Capital had invested in, I'll tell you one thing; if that had been my money, I would have been raising the red flag a long time ago.

So, let me start off with, No. 1, has the IG's office changed the way they audit these firms, not Arthur Andersen? Now, let's get the record straight. As I understand it—and you correct me if this is wrong—in 1988, we changed the law, at your request—and I must say that I still don't have any problem with that—we changed the law to require audits every 2 years, rather than every year. You said you didn't have the manpower to do it every year.

Is that correct?

Mr. GILLUM. That's right.

The CHAIRMAN. But I think the law, the rule has always been, has it not, that all these SBICs had to submit to an annual audit by an independent CPA firm.

Is that correct?

Mr. GILLUM. That's right, sir.

The CHAIRMAN. Has that always been the case, or has that just been the case since we changed the law to biennial auditing?

Mr. GILLUM. No. That's always been the case, sir.

The CHAIRMAN. They have to submit to an audit every year.

Now, let's go back behind what we know right now, for example, about Royal.

You say that the Small Business Administration set up a corporation, called "EWE," to liquidate and manage the assets of the, is it the "Royal Business Funding Corp.?" Is that the name of it, the RBFC?

Mr. GILLUM. Yes, that's right.

The CHAIRMAN. We will refer to it as RBFC from now on.

The Small Business Corp. set up a corporation called "EWE" to manage their assets, which included a development in Florida and a ski resort in Colorado.

Mr. GILLUM. And some other properties as well.

The CHAIRMAN. And some other properties, yes. But those were the two major ones.

They also concluded that, in order to preserve those assets, it would be necessary to make some additional investments in them.

For example, as I understand it, the ski lift was partly completed when they went under, and EWE concluded—and, incidentally, EWE was formed by three employees of SBA. Is that correct?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. And so, they decided they certainly had to finish the ski lift and do some other things to make it saleable. And the same thing was true of the development property in Florida. And you say in your report on those two corporations that both of those properties would have brought almost as much if they had sold them "as is," at the time than they brought after they had put $5 million into the two of them.

Is that a correct summary of your statement?

Mr. GILLUM. Yes, it is.

The CHAIRMAN. How did you arrive at that conclusion, Mr. Gillum?

Mr. GILLUM. Well, let me back up and address the issue of legality.

When we questioned the legality of EWE, what we're talking about there is use of the Government Corporation Control Act as the mechanism to do that. We don't believe that that act properly supported the use, the forming of EWE as a corporation.

That has been referred to the Attorney General, for an opinion on that particular issue.

In many respects, regardless of how the Attorney General comes down on that, it will be academic. We have never tried to imply that anybody did anything criminally wrong or materially out of line.

The CHAIRMAN. If I may interrupt you here, you do say in your statement, "While accounting records were reconstructed for about a 1-year time period, EWE did not have supporting records to verify the propriety of expenditures totaling $4.2 million and deposits of $2.8 million." There you have an expenditure of $4.2 million with absolutely no documentation, and you have to ask yourself what happened to the money.

I mean, you know, generally, that they completed a ski lift and they did some other things, but there is no documentation. And that is just an assumption on your part, that nobody put any money in their pocket, isn't it?

Mr. GILLUM. No, I'm not saying that. That's a function of what happened in the operation of EWE. What I am trying to address currently is the technical issue of whether the use of the Government Corporation Control Act to form the company was itself a legal act or not. We do not believe it was, and the Agency has asked the Attorney General to rule on that particular issue.

If the Attorney General should rule that it was, it still wouldn't change the findings of the report in terms of the operations of the company or anything else.

Basically, if the Attorney General would rule that that part were legal, basically it would provide the Agency another tool in the way to handle these things in the future. Our only concern then would be, as it has been all along, in the way that those activities were managed inside the Agency, the record-keeping, and the decisions that were made, or the lack of involvement in decisions by top Agency management in the forming and the carrying out of those activities.

The CHAIRMAN. Well, have you looked at SBA's internal documents that authorize the setting up of this corporation?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. Well, what was the reputed authority that they used to set up the corporation?

Mr. GILLUM. They cite the Government Corporation Control Act as the authority to do that.

The CHAIRMAN. The Government Corporation Control Act, and you say that there is no such authority in that act.

Mr. GILLUM. Yes, sir.

The CHAIRMAN. But this has been referred to Justice?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. For what purpose?

Mr. GILLUM. To determine whether or not they legally set up that corporation or can use that act to set up corporations like that in the future.

The CHAIRMAN. Well, about the only thing that would do would be to give us some guidance in the future either to use or not use that act as an excuse for setting up such corporations, correct?

Mr. GILLUM. That's correct, sir.

The CHAIRMAN. Now, Mr. Gillum, didn't the treasurer of EWE plead guilty to embezzling $40,000?

Mr. GILLUM. There was an official employee—and let me turn to Steve Marica to fill us in on that because I'm not sure exactly what the person's status was.

Steve.

Mr. MARICA. Mr. Chairman, when EWE was first formed, they hired a number of consultants and accountants to handle some of the processes in the book.

The CHAIRMAN. Can you pull your microphone up closer, please.

Mr. MARICA. The individual who pled guilty was one of the first accountants hired in New York City. That individual embezzled approximately $40,000 of EWE funds for his own use and has pled guilty to that. He was not an SBA employee.

The CHAIRMAN. Well, does that give anybody any heartburn, that we have all this money being expended and deposited with no documentation?

Mr. GILLUM. Well, it did us. That's why we wrote the report, obviously. It concerns us greatly.

The CHAIRMAN. When you say there is no documentation, did you go through all of these deposits and expenditures?

Mr. GILLUM. Sir, we have literally gone through literally tons of records on this thing. We're uncovering records as we go along today. The volume of records that were created and filed around are incredible. The problem with them is bringing them into any focus and having them readily available in a business-like fashion.

The CHAIRMAN. Now, do you have any suspicion that there was any criminal wrong-doing by officers of RBFC? I mean, every time a company goes under, that doesn't mean that somebody did something wrong. Businesses fold every day simply because they didn't have the business to stay afloat or because their management practices were so bad.

But did you find any evidence of any criminal activity on the part of the officers and directors of RBFC?

Mr. GILLUM. Steve, would you address that.

Mr. MARICA. Senator, at this point we don't have any direct evidence of criminal wrongdoing but the investigation is continuing.

The CHAIRMAN. Who is conducting the investigation?

Mr. MARICA. We are. We have two agents assigned to it and there has been extensive help from our audit division. It's under the auspices of the Southern District of New York. There is an Assistant U.S. Attorney assigned to the case, and our agents are working at her direction.

The CHAIRMAN. How many people do you have in your Audit Division?

Mr. GILLUM. In our Audit Division, we have 57 people currently.

Senator BOSCHWITZ. May I ask just a question here?

The CHAIRMAN. Certainly. I have two or three other questions that I want to ask. I have taken up too much time, and I apologize.

Senator BOSCHWITZ. That's perfectly all right. I just want to expand on one of yours. What was the sequence of events and what was this fellow convicted of?

The CHAIRMAN. Of misappropriating $40,000, and he pled guilty to it.

Senator BOSCHWITZ. At what time chronologically did that occur?

The CHAIRMAN. He was the treasurer of this corporation.

Senator BOSCHWITZ. Did that occur prior to the expenditure of the $4.2 million?

The CHAIRMAN. I don't know the answer to that.

Mr. MARICA. The time sequence of the embezzlement—let me clarify for the record that he was not the treasurer. He was an accountant that was hired by the corporation to handle some of the New York aspects of the liquidation process of Royal Business.

Senator BOSCHWITZ. Was he an independent agent?

Mr. MARICA. He was an independent accountant. He was not an SBA employee. No, sir. He was hired by EWE as an accountant.

Senator BOSCHWITZ. He was an employee of EWE?

Mr. MARICA. Yes, sir.

Senator BOSCHWITZ. So he was not an independent accountant?

Mr. MARICA. He was an independent accountant that was working on the payroll of EWE.

Senator BOSCHWITZ. When was he first indicted or cited for misappropriation of funds and when was he convicted? When was the $4.2 million expended?

Mr. MARICA. He was indicted in November 1989. He signed a plea agreement in January 1990, and in March 1990, it was accepted by the court. That ultimately resulted in his conviction.

I'm not sure when the $4.2 million was injected. Pete may know.

Mr. MCCLINTOCK. The $4.2 million that was not documented in an orderly fashion was in the beginning of the formation of EWE. It was in 1984. I believe that's the timeframe that this particular individual took the funds, took the $40,000.

Senator BOSCHWITZ. When was he booted out of the company, or when was his misappropriation first discovered?

Mr. MARICA. His misappropriation was discovered during 1989, in the course of the investigation, when we were going over the checks and books and records of EWE and some of those particular New York accounts. The misappropriation took place in 1985, I believe, and some parts of 1986. It was not a lump sum. He was doing it in increments. His employ with EWE ended some time I believe in 1986.

Senator BOSCHWITZ. Thank you.

The CHAIRMAN. Mr. Gillum, the Corporation Control Act specifically states, does it not, that an agency may not establish a corporation to conduct business without permission of Congress? Does it not?

Mr. GILLUM. Would you answer that?

Mr. McCLINTOCK. That's correct.

The CHAIRMAN. Is that correct, Peter?

Mr. McCLINTOCK. That is correct.

The CHAIRMAN. How long has Justice had this thing? It looks to me like the mother tongue is English and if you can speak and read English, and it says you may not set up such a corporation without Congressional approval, and this certainly was set up without Congressional approval, you don't have to be a rocket scientist to know that this corporation was illegally set up, do you?

Mr. GILLUM. Well, that was the position we took. To answer your question specifically, it was referred on September 1 of last year.

The CHAIRMAN. Well, I'm going to ask SBA to bring us some of those internal documents that they considered as authority for setting the corporation up. No point in looking for scapegoats. I just want to make an issue of this because I don't want it to happen again. But the main thing we're here for is to set up new auditing procedures and to determine the viability, efficacy, and desirability of continuing SBIC, as far as I am concerned.

Now, they do have some great success stories. But they also have some miserable ones, just like we are here talking about this morning.

Mr. GILLUM. Our point about the Government Corporation Control Act is if Justice wants to come down and rule that it is a proper use of that authority, then all we're saying is that's fine, then let's have the proper internal controls and business procedures to operate under that authority; that if you want to set up a corporation, have some process internally where at least a business plan is put together, some reasonable staffing is done, and the Administrator or some appropriate management level is brought into the process to say yes, we want to use that device because it's a good tool to help us do the Government's business.

That's the only position that we've ever taken on that with respect to the legality of that.

The CHAIRMAN. Mr. Gillum, let's turn to River Capital for just a moment.

We have River Capital being audited by Arthur Andersen in December 1987, correct?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. And I have seen your report, in which you say that Arthur Andersen was seriously deficient in that audit. We will give them an opportunity to say otherwise. And they may be right.

I can say one thing. If that audit was conducted according to the kinds of what we call the "generally accepted accounting principles," then we have to have a new auditing mechanism immediately. This is because here you have an audit saying that this company is just "hunky dory" in December 1987 and I think it was then, in what, in August that they shut their doors and went into liquidation? Now here is a company that Arthur Andersen says is worth $28 to $30 million. They list the stock and all the companies they own stock in, the debts that they hold in these 40 companies that they invested in. And then, 8 months later, no, 7 months later, they are out of business, and "Uncle Sugar" is going to be left holding the sack. We had about a $28 million exposure just for the Government's share, and we'd be lucky to recover $2 to $4 million of that.

So we lose $24 million just 7 months later.

Now my question to you is this. Have you had a chance to figure out what on Earth went wrong? Completely aside from Arthur Andersen's audit, have you had a chance to interrogate the officers and directors of that company and what they have to say for themselves as a result of the board meeting they held? I assume they held it. Arthur Andersen says their auditors sat in the board meeting and let the board of directors of River Capital discuss openly the value of each one of these companies they had invested in. And it was that discussion, apparently, that helped Arthur Andersen arrive at a conclusion that these investments were sound and that River Capital really had about $28 million in assets.

It is hard for me to believe that there isn't some serious culpability on the part of the officers and directors of River Capital when they sat there and made these statements, apparently in front of Arthur Andersen, and misled Arthur Andersen into believing that everything was "hunky dory," and 7 months later they are out of business, broke, and can't even begin to service their debt. And we find out that their net assets are probably going to be less than $4 million.

My question: Have you talked to those board members and the officers of that corporation as to what on earth was going on that day in that board meeting?

Mr. GILLUM. Not yet. The reason we haven't is because the matter is currently pending before the U.S. Attorney's Office in Alexandria, and we are being guided by that office in what we do.

There are also a number of decisions on the table that the Agency is working on with respect to any potential liability by the board of directors and by the accounting firm, and whether or not the Government goes forward with the litigation.

I am not privy to those discussions, but I know that that dialog is going on.

The CHAIRMAN. Well, has the IG's office of SBA pretty much left that, then, to the Justice Department?

Mr. GILLUM. Not exactly. We're working with them and, as they tell us that we can be free to go and do things, that it won't compromise the Government's position with respect to anything the U.S. Attorney wants to do or that they want to do civilly in terms of litigation, then we'll move forward on that. But we're not running off like a bunch of Texas Rangers to go trod on this thing until we get guidance from them.

The CHAIRMAN. Gentlemen, I have taken too much time. There are other Senators here who obviously want to ask questions.

So let me ask you this last question.

We have 175 SBICs in liquidation. We have 375 remaining, and of those, is it 23 that are problems, or 27?

Mr. GILLUM. Well, when we do our annual planning to look at how we want to approach doing the work in auditing the SBICs, we look at a number of things. I think that the latest numbers we showed—we pulled this information in from the Agency and used their numbers and figures—but I think 19 percent of that total 404 were rated by the Agency as above average in risk.

The CHAIRMAN. You mean above average risk?

Mr. GILLUM. Yes, sir, in terms of the figures.

The CHAIRMAN. Well, my question is this. Not only do I want a moratorium on issuing any further SBIC licenses, I want to know, through an in-depth audit, the kind of audit that GAO recommended in May 1988, that we start doing on these, the condition of the others. I mean, we only have $1.5 billion exposure here, so we're not looking at an S&L situation; but, as I say, we ain't looking at "beanbag," either.

What I want to know is what is the real financial condition of the other SBICs? Now, do we have anything other than just a CPA audit that has been sent to SBIC, plus some that you have done your biennial audits on? Do we have any additional comfort in knowing that those companies are viable and that they aren't going down the tubes with RBFC and River Capital?

Mr. GILLUM. Well, in terms of whether they are going to go belly-up tomorrow, I don't really know. But I do think that the people in the Investment Division, who work with these companies on a day-to-day basis, have a very good understanding of what's going on in the industry. They have a lot of input outside the audits, reports that are being made by the companies as they do financings or they ask for additional financing, or as they do investments, and so forth, and the Investment Division has the ability to ask for information, et cetera, from these companies. I think those people are quite professional and have a very good understanding of what is going on there, and they could answer that certainly much better than I could.

The CHAIRMAN. Mr. Gillum, Arthur Andersen, on River Capital, gave a qualified opinion. That's the reason I say they may have thrown up enough red flags and issued enough caveats to exculpate themselves of any negligence in this. I'm not judging that one way or the other. But did the IG's office take any action or recommend any action pursuant to the receipt of Arthur Andersen's audit of River Capital, or did you take that audit to mean that they were in great shape?

Mr. GILLUM. Well, the past practice, when those reports were received annually, was to turn them over to the individual auditor on our staff, and then when they went out and did the annual examination of the licensee, they looked at the report in that process and evaluated it, and then went out and did the examination.

If the auditor saw a problem in the CPA firm's work, then they would follow up, go look at their work papers, check it, and go forward with the audit.

One of the things the GAO did in its 1988 report was say that we really didn't have a good quality assurance program. I agree with them 100 percent.

What GAO is talking about, in terms of an assurance program, is us having a centrally directed way to get all these reports on these companies and to look at them in some unified way against established criteria in a regularized process, so that we can have an idea of the quality of work being done across the board.

GAO also says, and I agree with them 100 percent, that those audits should be done in accordance with generally accepted Government auditing standards, not GAAS but what they call GAGAS. I agree with them on that.

That's what that report says. There are firms out there now, because we don't have an assurance program in place and operating like I would want to, that need to get in conformance with GAGAS. We also have, in addition to that, a proposed draft audit, to change the Agency's regulations from the GAAS kind of standard that is in the Agency regulation now to get them under GAGAS.

GAO takes the position that if you're going to have CPA firms auditing loan activities and Government loan guarantees, those audits should meet generally accepted Government auditing standards as promulgated by GAO. We agree with that. We want to see that happen.

We need to get the Agency to change that regulation internally. We need to get them to comment on our proposal and work with us to produce the guide. Then we need to set up the Quality Assurance Program in the Agency.

It's one of my highest priorities, to set up a review team to do CPA quality assurance work on an annual basis.

I can't do that as my vacancy rate increases and my dollars decrease to where I can't hire anybody. I'm not crying here about that. I'm just stating a plain, simple fact: That if my attrition is greater than my ability to hire, I cannot bring the kind of people in I need to do that job.

We have an announcement out now, and in the next half of this year as moneys become available because we are lapsing money on so many vacancies that we have, that is going to be one of our No. one hires, to get that program set up.

That will do a lot to help insure the quality of audit work being performed by CPAs.

It's much better than trying to contract out, which would be a very costly venture, all of the 400-some companies audits at the same time. I would certainly caution against that kind of shotgun approach.

Of the 400, many of them have very good operating records. We know from our own experience in doing examinations of them that they are in good shape. Probably a third of them have no Government financial exposure. And so, there is not a lot of reason for us to spend additional monies or to put resources into looking at those.

The CHAIRMAN. If we don't have any exposure, I'm willing to exempt them.

Mr. GILLUM. I am, too. That is part of the biennial requirement, that's why I'd like to get a periodic requirement, so we could skip over some of them when we don't have any financial exposure.

The CHAIRMAN. Well, you can understand why this Committee would necessarily be a little antsy, when you have a corporation like River Capital and a short 2 years ago we were told it was in wonderful condition. But, all of a sudden, we're going to lose $24 million to $28 million. We have that exposure.

How am I to conclude that the some 300-plus remaining SBICs, or 200 or whatever the number is, where we have $1.5 billion in exposure, how am I to conclude that they are all just getting along great?

Mr. GILLUM. Well, I wish I could tell you that they are. But I can't tell you that, either. You used the word "antsy." I'll use the word "concern," and I use the word "concern" to avoid any sort of hysteria or implication that this is another S&L thing, because I don't know if it is.

I come to the Committee here trying to talk about those things that we know about, those things about which we had evidence or a body of evidence which we put together that we can really talk about.

The CHAIRMAN. But you can't give this Committee the kind of assurance that we'd like——

Mr. GILLUM. Not at the moment.

The CHAIRMAN [continuing]. As far as all those other SBICs out there. Maybe you're right. Maybe they're all just going great guns. They have done some good things in the past, obviously.

Mr. GILLUM. Maybe they are. But certainly, as IG kinds of people, if we don't look at them in some regularized fashion—and I'm not talking about the basic licensee audit, I'm talking about doing a kind of internal auditing as GAO does, where we look at the programmatic operations of everything in the Agency and do that on some reasonable cycle—I feel very uncomfortable about it. You know, there's a $15 billion loan portfolio out there that we don't know a lot about either because we haven't spent a lot of time on it. There is a whole financial operation out there.

The CHAIRMAN. But you say you don't have the manpower to do it, though. And you object to the suggestion that we hire firms to go out there and do this on a crash basis.

Mr. GILLUM. Not object. I'm just trying to say let's not do it with a shotgun approach. Let's do it in some orderly fashion.

If you want us to look at the 19 percent or so that are believed to be in the high risk category, I'll be happy to divert resources, change our annual audit plan to refocus on those. We'll look at the work that's been done by the IPAs in those areas and see if we can come to some reasonable conclusion.

At least we can certainly look at the method of evaluating the companies.

The CHAIRMAN. Mr. Gillum, I want to reemphasize this because I think we may be like two ships passing in the night here. My concern is not the 19 percent we already know are in difficulty. My concern is that if we are relying on audits, like this audit we got in December 1987 on the remainder, which we believe to be healthy, we may really be setting on a powder keg here.

What I'm saying is those audits aren't worth a "tinker's damn." They don't tell us anything.

Mr. **Gillum**. Well, I don't know that we know that.

The **Chairman**. I know we don't know it. But I want to know it. That's what I'm saying. I want to find out.

Mr. **Gillum**. I understand that. In terms of the 19 percent that have been identified as higher risk, I think the decision that they are high risk isn't based strictly upon the audit reports that are done by CPAs. There is a whole body of knowledge and information. The Investment Division people know because of their dealings with them. Some of them are without exposure, and so forth. This should give some reasonable comfort that those are not in the higher risk area.

The **Chairman**. I have taken too much time.

Senator Boschwitz.

Senator **Boschwitz**. I think your line of questioning was very helpful, Mr. Chairman. As I think of the various people at SBA who must be overseeing these accounts and must be having a relationship with the SBICs, I find it amazing that some of these things were not identified. Other than the Inspector General's office, I presume there is oversight done by many people within the SBA.

Tell me a little bit about EWE. It was formed by three past SBA employees, or present SBA employees?

Mr. **Gillum**. Present, employees.

Senator **Boschwitz**. But yet, you say that SBA senior managers were not adequately informed of EWE's existence until recently, and, therefore, were not able to supervise its' operations. But yet, it was formed by present SBA employees? I don't understand that at all.

That was in the form of a question, I might add.

Mr. **Gillum**. All right. Let me see if I can back up and explain.

Three employees, one at General Counsel, a couple in the office of the——

Senator **Boschwitz**. Did you say one was the General Counsel?

Mr. **Gillum**. No. One in the Office of General Counsel, one of the attorneys, and a couple of employees in the Office of Portfolio Management are the principals that are identified as the organizers, the incorporators of EWE.

Now one should not be misled. These employees didn't go out and create a corporation in Delaware and put the stock in their name or anything like that. They created it, put the stock in the name of SBA and then operated it.

Our problem with it is that——

Senator **Boschwitz**. And then they went out and made the investments in these ski lifts, and in the property down in Florida?

Mr. **Gillum**. Well, the company was created to transfer the assets of Royal Business Funds Corp. into that company to make it operate.

Senator **Boschwitz**. And that was in 1982, is that correct?

Mr. **Gillum**. That was back about 1984, when they created EWE. I think the company went under, in liquidation, about 1982.

Senator **Boschwitz**. SBA placed Royal Business Funds in liquidation in 1982 and formed a corporation known as EWE?

Mr. **Gillum**. Right.

Senator BOSCHWITZ. So it was in 1982.

Mr. MCCLINTOCK. In 1984, sir.

In 1982, Royal Business Funds was in receivership, and was in receivership for 2 years, until a consent order was issued by the judge to transfer the assets to SBA.

Now, some of the investment in the ski area was done during the receivership.

Senator BOSCHWITZ. The receivership overseen by whom?

Mr. MCCLINTOCK. SBA was the receiver and it was overseen by a court, by a judge.

Senator BOSCHWITZ. So, SBA was the receiver, it was overseen by the court, and there weren't proper records? Is that correct?

Mr. GILLUM. [Nods affirmatively.]

Mr. MCCLINTOCK. We didn't look at the receivership.

Senator BOSCHWITZ. Why is the General shaking his head "yes" and why are you not saying yes or no?

Mr. MCCLINTOCK. We actually didn't focus on the receivership. Our audit focused on the establishment of EWE and the records that were available.

Senator BOSCHWITZ. What does that mean you "didn't focus on it?" Let me ask the question again.

EWE was formed and it was run by three SBA employees, including one from the General Counsel's Office. However, SBA senior managers were not adequately informed. These three people thereupon went out and invested in a ski operation. Which ski operation was that, incidentally? What is the name of it?

Mr. MCCLINTOCK. Conquistador.

Senator BOSCHWITZ. Conquistador? That is not a part of Colorado that I am familiar with, Mr. Chairman.

Mr. MCCLINTOCK. Neither are the skiers.

Senator BOSCHWITZ. So that's part of the problem, I see.

The CHAIRMAN. They stayed away in droves.

Senator BOSCHWITZ. So you're telling me there was a receiver, there were three SBA employees who made investments and didn't keep adequate records.

Mr. MCCLINTOCK. That's correct.

Senator BOSCHWITZ. Wow.

The CHAIRMAN. No kidding.

I was up till midnight the last three nights waiting for all that stuff. That's not the only thing that's "wow."

Senator BOSCHWITZ. But how can that be? How can it be that SBA senior managers were not adequately informed? It defies the imagination, I must tell you.

Mr. GILLUM. Well, we talked about that.

Senator BOSCHWITZ. Then all you do is tell me that you don't have enough people down there. I mean, there are people in the SBA who are supposed to be overseeing. It doesn't matter if you have more people. You had three people, including one from the General Counsel's Office, in this corporation, and they still screwed it up, or they didn't keep proper records.

Maybe Stockman was right. The whole thing should be discontinued, Mr. Chairman. I recall his activities of about 8 or 9 years ago here before the Committee. Really, one has to wonder, as the Chairman wonders, what in the world our exposure is elsewhere if our own people are so careless and if there is not adequate recordkeeping.

Is that a customary thing, that we have a bunch of bureaucrats making these business decisions?

Mr. GILLUM. I think EWE and the Royal Business Fund thing is very unique and distinct. Certainly, it is the rarest thing that I have run into in my 28 years in Government.

You know, I hesitate to make these broad, sweeping kinds of conclusions that would condemn the operations of the Agency and its many hard-working employees. I really can only comment on what we have audited or been able to audit. I have concerns about the things we have not been able to do.

Senator BOSCHWITZ. There is now a biennial audit and the biennial audit came about because of the requests that the Agency made that they could not keep up, in effect, with the annual audits. Is that correct?

Mr. GILLUM. No.

I pushed for the biennial audit because we were focusing the majority of our resources on nothing but licensee examinations, and we were doing that to the detriment of coverage of other agency programs, and we were impairing our audit operations because we were not doing audits in accordance with the Inspector General Act under General Accounting Office guidance.

Senator BOSCHWITZ. Are there others in the SBA who also audit these matters?

Mr. GILLUM. Pardon?

Senator BOSCHWITZ. Does the SBA have an Audit Division that oversees the SBICs as well?

Mr. GILLUM. Well, we are the Audit Division that oversees the SBICs.

Senator BOSCHWITZ. And do you also oversee the entire loan portfolio? Is that also within your jurisdiction?

Mr. GILLUM. Yes, sir.

Senator BOSCHWITZ. Aren't there case workers, so to speak, or aren't there people assigned to the SBICs within the agency who determine whether or not loans should be made and who also are part of the oversight process?

Mr. GILLUM. Oh, clearly; yes. That is in the finance and investment operation and with SBICs in particular, the Investment Division Program.

Senator BOSCHWITZ. Do you have a relationship with those people? Do they point out things? Do they come to you and say that you ought to take a look into this or that?

Mr. GILLUM. Oh, clearly. We also invite their comment. We just sent out letters to all the regional administrators around the country, asking them for their suggestions as to areas that should be considered for audit coverage during the next year.

We have a rocky relationship at times with the Investment Division, the Finance and Investment folks. They clearly don't like our Royal Business Funds Report. They generally don't like any of our reports that are critical. I guess nobody does when they are being audited. It is not a good thing.

But they are honorable people, and they are trying to do their jobs. I think one of the things that we have tried to comment as best we could, although not having good, hard data available to us, is to try to focus on claims that they have about lack of resources to do that monitoring. We think there is a need for additional resources within the Investment Division and the Office of Portfolio Management to carry out some of these functions, to give those people a better handle and a better way to do their jobs.

Senator BOSCHWITZ. The actual loss rate of the SBIC Program in fiscal year 1989 was about 1.75 percent. My staff tells me that the ultimate loss rate was estimated to be about 14 percent.

Is that correct? I didn't quite understand what that meant, I must say.

Mr. GILLUM. Well, in the past they have had two different ways of computing some of those losses. Very recently, the Administrator has directed that they change that. Part of that will probably be driven by the IG Act Amendments of 1988, which require that when the Government has a receivable, it be valued and placed in the books and records of the Agency. So they are moving toward a process now, it is my understanding, where, as a company would go into liquidation, they will try to make a very timely appraisal of the value of those assets, and book those on the records of the Agency and then measure their recoveries against that record as they move forward. This would include writing down any of those assets as might be appropriate to do it in a business-like fashion.

Senator BOSCHWITZ. What were the two different types of evaluation of losses? What does that mean?

Mr. GILLUM. Well, I wish I truly understood it.

Senator BOSCHWITZ. Well, if you don't, then who does?

You are the Inspector General and you don't have an understanding of how they calculate their losses?

Mr. GILLUM. Well, I am the Inspector General, sir, but I am not omnipotent in all matters. I am going to have to tell you that there are times that I'm going to tell you that I just don't know. I don't like sitting here and saying that I don't know. But I would rather tell you that I don't know than to just wander around.

Senator BOSCHWITZ. We don't expect omnipotence. Certainly we are not omnipotent. But I think it is not unreasonable to ask how they calculate their losses. It is that over which you are given some oversight, I thought. Perhaps I am mistaken.

Could you please explain to me the two ways, and then I will turn to my colleagues, the two ways the losses are calculated? I could not understand that the actual loss rate for 1989 was only 1.74 percent but the ultimate loss rate was estimated to be at 14 percent, 13.9 percent. You say there are two ways of calculating the losses. Please describe those two ways to me.

Mr. GILLUM. Well, I have told you now, Senator, that I cannot precisely answer that. I would be happy to get it and submit it for the record.

Senator BOSCHWITZ. Well, perhaps Mr. McClintock. Can you answer how they are done?

Mr. MCCLINTOCK. I am not sure what you are referring to. But I do know in the SBIC Liquidation Program there are periodic assessments by the program people as to how much value there is to the portfolio that is maintained by SBA. They provide that information to the Comptroller's Office, who then uses that as a basis to write down the debt that would be received by SBA, or write down the value of the asset on SBA's books.

I am not aware of the two different methods. But I do know that that area is an area of concern and is being looked at and addressed by the Comptroller's Office and the Office of Portfolio Management.

Senator BOSCHWITZ. Well, are there two different methods of assessing a loss or are there not two different methods?

Mr. GILLUM. Well, maybe that was a misspeak by saying two methods.

I know that there was a process that was not viewed as in the best interests of the Agency and the Administrator has directed that they change the process. If using the words "two methods" confuses the issue, let me back up on that.

I would be pleased to provide additional information later that would straighten out, but I just cannot do that now, Senator.

Senator BOSCHWITZ. The actual loss rate for the SBIC program for Fiscal Year 1989 was 1.75 percent. The ultimate loss rate was estimated to be 14 percent.

Do you have any idea what that reference is to, Mr. Marica?

Mr. MARICA. No, sir. I don't.

Senator BOSCHWITZ. Do you, Mr. Gillum?

Mr. GILLUM. Only in the vaguest sense. I just do not feel comfortable with trying to explain it. I have said that and I apologize for that. But I just cannot do it, Senator.

Senator BOSCHWITZ. Well, then, perhaps you can do it in writing. Tell us about this new way of evaluation that the Administrator is seeking.

Mr. GILLUM. All right, sir.

[The information referred to follows:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

MAY 29 1990

Honorable Rudy Boschwitz
United States Senate
Committee on Small Business
Washington, DC 20510-6350

Dear Senator Boschwitz:

I am in receipt of your letter of May 9, 1990, requesting clarification of the Small Business Administration (SBA) loss rate calculations for the Small Business Investment Company (SBIC) program.

The primary reason for the large difference between the two rates reported is that the liquidation process for the SBIC program is very complex due to the large portfolios that are individually held by a SBIC. Therefore, the classification of a SBIC debenture as "charged-off" takes much more time than that of a regular SBA loan. Consequently, the liquidation activity is not reflected in the actual loss rate but in the ultimate loss rate.

The SBA produces an annual loss study that includes two distinct, but related loss rates. This study is revised and updated annually; therefore, the loss rates change annually. The first rate reported is the actual loss rate. This rate is calculated by dividing the cumulative principal amounts charged-off, less any amounts recovered, by the cumulative disbursements of SBIC's since inception of the program. The resultant figure is the program loss rate through that fiscal year.

In addition to the actual rate, we compute a second loss rate referred to as the ultimate or "projected" loss rate. This rate reflects our projection of the total losses accruing to the SBA due to further maturing of the existing portfolio. To obtain this rate, we add a projection of future principal amounts to be charged-off to the actual amounts charged-off to arrive at a projected loss amount. The projections are based on the principal amount outstanding and the status of the portfolio, i.e. principal amount current vs. principal amount in a non-current or liquidation status. Since the SBIC program has a substantial amount of principal that is in a liquidation status, the projected future losses are significant. The resultant estimated losses are divided by the same cumulative disbursements referenced above, resulting in an ultimate or "projected" loss rate.

I hope that this explanation will clarify your understanding of the SBA's loss rate calculations. If you have any further questions, please let me know.

Sincerely,

Lawrence R. Rosenbaum
Comptroller

The **Chairman**. Senator Lieberman.

STATEMENT OF HON. JOSEPH I. LIEBERMAN, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator **Lieberman**. Thank you, Mr. Chairman, and thank you for convening these hearings.

Thank you, Mr. Gillum. I must say that I find this material astounding and really infuriating.

I want to just return to EWE because EWE sounds to me, if I may say so, like the Iran-Contra scandal of the small business world. I do not mean to overstate things, but there are really some remarkable similarities. As you describe it, you have a small group of employees of the Federal Government who, essentially, chose to carry out their mission through unauthorized means, on their own, without, apparently, telling their supervisors.

I find your conclusions very powerful and infuriating. You say what they did in creating EWE violated the Governmental Corporation Control Act by giving SBA a vehicle to operate the liquidation outside the Treasury fiscal laws and other Federal regulations, resulting in:

1. depositing funds untimely into the Treasury;

2. dispersing funds without obtaining Treasury Department authority to do so; and

3. augmenting SBA's salary and expense appropriation by paying for official travel with EWE funds and lending money to pay for other SBA expenses, and awarding contracts without following established procurement practices.

Now that sounds like a rogue operation conducted within a governmental office. You also allege that there were some conflicts of interest. Consultants were retained who were EWE board members; five consultants who had previously worked for Royal.

It is heavy stuff.

Are you absolutely convinced that the superiors of these folks at SBA did not know what was going on in the creation and operation of EWE?

Mr. **Gillum**. We went back through the years and interviewed the past Administrators of the Agency, and none of them had any knowledge of that activity. We found that it was unique enough, and in one sense, if done properly, might have been on the leading edge of novelty in terms of the way to handle things, but certainly sufficiently unique enough that it concerned us that there was not a written record of a business plan, a set of things in there which we could go to and see that top management, including the Administrator, had an opportunity to say that it looked like a reasonable kind of thing, so let's take a shot at it, let's try it.

If we would have seen that kind of documentation, we clearly would have taken a different approach. But we did not find that. We found that of concern to us and I think you can see the rest of it in the report.

Senator **Lieberman**. I presume that the people—these were three individuals who set up EWE?

Mr. **Gillum**. Yes.

Senator LIEBERMAN. I assume that they knew they were doing something unique and unprecedented.

Mr. GILLUM. I believe so. Yes.

Senator LIEBERMAN. Did you question them as to why they did not inform their supervisors of what they were doing?

Mr. GILLUM. Well, part of the reason that was given was that there was a belief among some, and there are always, certainly in this town, people who have different opinions, that they had delegated authority to run that program and that that delegated authority gave them the right to do that.

Senator LIEBERMAN. Are they still working for the Agency?

Mr. GILLUM. Oh, yes.

Senator LIEBERMAN. Let me ask about the status of your investigation into EWE.

Mr. GILLUM. It's ongoing.

Senator LIEBERMAN. It's ongoing?

Mr. GILLUM. Yes, sir.

We took a two level approach to it, because of the seriousness of the initial things that we ran into in terms of what we consider to be lack of proper internal controls, and so forth, we chose to do our initial thrust as an audit activity, to have the auditors look at it. That is the report that you see.

As we moved along with that, we came to the point where we could produce a report—and the reason we wanted to do that was to place in the hands of top management a report with some recommendations upon which they could take some corrective action. As we got to that point, then we shifted over into the investigation mode and Steve Marica's investigators have picked up. That matter is still ongoing.

Senator LIEBERMAN. What is your timetable? How soon do you think you will complete the EWE investigation?

Mr. MARICA. Senator, it is hard to say at this time. The process of the investigation has me somewhat worried. As was mentioned before, in the area of records we had a hard time obtaining all the records that related to the various operations of EWE, and I am not sure to this day that we have them all.

There were situations where the investigators asked for records and were told that there were no records available. Then, later on, when a Grand Jury subpoena was issued, in one particular instance, as many as 60 boxes of records were located.

We are in the process still now, today, of going through those records, as well as conducting interviews all across the country.

We have assigned two agents full-time to it, and that is about 15 percent of the entire investigative staff. There has been good support, when needed, from the Audit Division.

We have one conviction to date and the investigation is being pursued by the Southern District of New York. But as far as getting a reasonable timetable which I would feel comfortable in relating to you today, it is just not possible.

Senator LIEBERMAN. The conviction, I take it, is of the treasurer, who was convicted of embezzling $40,000?

Mr. MARICA. Yes, sir.

Senator **Lieberman**. Am I correct in assuming that he was not an SBA employee? He was somebody hired by EWE, the corporation that the SBA folks set up?

Mr. **Marica**. Yes, sir.

Senator **Lieberman**. In one of your other conclusions, you say that you did not have supporting records to verify the propriety of expenditures totaling $4.2 million by EWE and deposits of $2.8 million. You have a total of $7 million there.

I am just wondering whether you feel it is appropriate that these three individuals should be continuing in their work at SBA while the investigation is going on. You have reached some fairly serious conclusions about what they did already, although the report is ongoing.

Do you think they should still be in their positions at SBA?

Mr. **Gillum**. Well, clearly that is not my judgment to make, whether they are or not. But I would like to point out that, while we had our disagreements and our ups and downs with some of these folks during the course of the audit and the investigation, there has never been anything to suggest to me that anybody operated with bad intent or evil motive. Certainly there has never been any suggestion to this date in the course of the investigation that anybody tried to, as employees of the Agency, that they tried to profit from this in any way.

Senator **Lieberman**. Well, forgive me, but that is what Colonel North said, too. And I believed him. He did not operate with evil intent. He operated with the highest of motivations. But the court has found that he violated the law.

Senator **Boschwitz**. And these guys apparently didn't keep records.

Senator **Lieberman**. They didn't keep records in EWE.

Senator **Boschwitz**. Yes, that's right.

Senator **Lieberman**. Is there a prospect that this matter might eventually be forwarded to the U.S. Attorney for criminal prosecution, or to the Justice Department or the U.S. Attorney for civil prosecution?

Mr. **Marica**. It is in the hands of the criminal side of the U.S. Attorney's Office in the Southern District of New York.

Senator **Lieberman**. EWE is?

Mr. **Marica**. Yes.

Senator **Lieberman**. And not just in regard to the Treasurer?

Mr. **Marica**. The entire investigation is being coordinated by the Southern District.

Senator **Lieberman**. OK. I appreciate that. So they also have an ongoing thing. I did not understand that. They also have an ongoing investigation.

Mr. **Marica**. Yes, sir. The agents who are assigned are working for an assistant in this.

Senator **Lieberman**. OK. Excellent. I appreciate hearing that.

You said at one point that there were 14 ongoing investigations now, correct?

Mr. **Marica**. Yes, sir.

Senator **Lieberman**. Are those financial or criminal? In other words, are there any others? Are those 14 that your office is carrying out?

Mr. MARICA. The 14 that were referred to are all criminal.

Senator LIEBERMAN. They are all criminal?

Mr. MARICA. Yes, sir.

Senator LIEBERMAN. So they are all under the supervision of the U.S. Attorney?

Mr. MARICA. Yes, sir.

Senator LIEBERMAN. And you have other work going beyond those 14?

Mr. MARICA. Yes, sir.

Senator LIEBERMAN. Let me step back, if I can, apart from these two cases, and ask you this general question based on what you have done.

As I go back over the record of the SBICs, this was a good idea. It was a good idea to pool private capital and some public backing and create investment and venture capital. It's the same situation we're talking about now where we are looking to stimulate our economy to create economic competitiveness.

Without expecting a thesis, a doctoral thesis in response, what happened here? Where did this go wrong?

Was it conniving, private people, who figured out a way to con the Government? Was it inadequate supervision by the Government?

What happened?

Mr. GILLUM. I would not want to conclude from your question that we should indict the whole program because we, frankly, just do not have the kind of information to draw that kind of conclusion.

We have these anecdotal situations of very serious kinds of problems, and we are pursuing them as vigorously as we can in each one of those cases.

I think it would take a lot more look-see and certainly a different kind of in-depth review to step back and to try to conclude that the program has totally gone amuck or that it is an unsalvageable program.

Senator LIEBERMAN. Well, I'm not saying that. But the numbers you presented are bleak. I mean, 170 of the SBICs failed; 14 are in criminal investigation; almost 20 percent of the 404 remaining you consider to be high risk. That says to me that something bad happened with a good program, or with a good idea, anyway.

Mr. GILLUM. Part of the things that we don't know, though, are these. Well, for one thing, we do know that this program is different than a lot of other loan programs in that it is a venture capital operation. By its very nature it is more risky, in a sense, than some other kinds of programs. A lot of money goes into equity investments. S&Ls and other lenders are most often at least putting money into property and some of these SBICs don't. So the nature of the program is somewhat more risky.

Senator LIEBERMAN. So when we go into these kinds of programs do we then just have to assume there will be these kinds of problems?

Mr. GILLUM. Well, no.

Senator LIEBERMAN. What would you say, if we were going to do it again, that we should have done differently to try to avoid these problems?

Mr. **Gillum**. Well, what I don't want to do is jump to the conclusion that it is all bad.

Senator **Lieberman**. I don't, either.

Mr. **Gillum**. Some of these can be driven by economic and other kinds of situations. If you take a generally more risky program than some others, then I think it is not unreasonable to say that you have to be concerned that if downturns in the economy and other such things happen, then these might be impacted more.

We have a number of things that we want to do to try to help the program, to help our comfort level with it, and one of those is to ask the Congress, and to keep asking the Congress, to relieve us of the biennial and these structured requirements of what we have to do, to give us more freedom to operate under the basic controls of the Inspector General Act. That is, to look at these licensees on an annual basis and sit down with management, evaluate them in some criteria-based planning process, which we have in place but does not operate as well as we would like to; to look at each one on an annual basis in terms of what their exposure is, what our experience has been with them in terms of our ability to audit them and cover them; what the Investment Division's experience with them is, what they are reporting on an annual basis, and so forth; and then focus our resources very, very narrowly on those that judgment tells us require attention, and not to be doing half of them or all of them on a cyclical basis.

In addition to that, we want management to have some better ability to do some monitoring of those activities to fortify us.

Senator **Boschwitz**. Would you yield?

Senator **Lieberman**. Certainly.

Senator **Boschwitz**. I look at your recommendation of steps to insure future integrity, but I don't see any. The only thing that you have asked the Congress for in earlier testimony is that you want more money to hire more people. You have just now said that we are restraining you in some way. That did not appear in your testimony, I might say.

The only thing that appeared in your testimony is that the biennial reports or oversights were made at your request earlier.

What is this demand upon Congress? What have we not done and how is the blame now being shifted to us? It may be that it is properly here.

Mr. **Gillum**. Well, certainly in my March 9 statement, we covered wanting to get statutory relief from the biennial requirement.

When we initially approached the annual requirement, the statutory requirement for annual examinations, we initially wanted to get the language changed from "annual" to "periodic, in accordance with the Inspector General Act," so that we could go back and work with management and apply reason and process to what we are going to do, rather than following a statutory formula, which eats up our resources.

There was a compromise made and we were given half a loaf. We were given from annual to biennial. We accepted it, graciously and happily, because it was better than getting nothing.

Our experience has been that, as we have moved under the biennial arrangement and tried to do more thorough work, we are spending twice as much time auditing as we used to under the annual requirement. So it has been a net wash for us in terms of resources. So I hope we have been clear on that in all the written submissions we have made to get relief from that so that we can operate under the Inspector General Act.

Senator LIEBERMAN. Thank you, Mr. Gillum.

[The prepared statement of Senator Lieberman follows:]

STATEMENT OF
SENATOR JOSEPH I. LIEBERMAN

SENATE COMMITTEE ON SMALL BUSINESS
HEARING ON SMALL BUSINESS INVESTMENT COMPANIES

Wednesday, May 9, 1990

Mr. Chairman, Thank you for calling these very critical hearings on the health of the Small Business Investment Company industry with particular focus on two recent and quite costly failures, River Capital Corporation and Royal Business Funds Corporation.

I don't meed to mention the critical role S.B.I.C.'s can play in our economy, particularly in light of a recent tightening of credit for small firms. S.B.I.C.'s, with their venture and technical expertise, offer small businesses the opportunity for funds they would otherwise have no ability to secure individually or through conventional lending institutions. When successful, S.B.I.C.'s bring high risk products and services to the market at a relatively low risk and cost to the government or the economy.

Recent reports, however, suggest that something in the program has gone wrong. We are now facing a situation where 170 S.B.I.C.'s have failed and represent a potential exposure for the government and the taxpayers in excess of $500 million.
Additionally, we will hear Inspector General Charles Gillum testify that of the 404 S.B.I.C.'s presently in operation, 19% represent an above average risk, and 14 are presently being investigated by the Justice Department.

As I reviewed the testimony and audit reports, I could not help but conclude that there are shortcomings in S.B.A.'s oversight of existing program participants and the liquidation of failed ventures. It is my understanding that the S.B.A. has only 7 staff members, including one part time secretary, to handle the liquidation of over 170 S.B.I.C.'s with over 1,000 equity investments. The cases of both Royal and River Capital clearly illustrate these shortcomings.

Whether technically legal of not, when the S.B.A. sets up a wholly owned corporation, EWE Corp., and develops a ski resort and a Florida property, and circumvents Treasury Department and Regulatory liquidation procedures, with only scant accounting records, it raises serious policy and supervisory questions about the program.

Again, Mr. Chairman, thank you for convening these very important hearings, and I look forward to the testimony of Mr. Gillum.

The **Chairman**. Thank you.

Senator Kasten.

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator **Kasten**. Mr. Chairman, thank you.

I want to associate myself, Mr. Chairman, with your views and those of the Senator from Connecticut and others here.

I think the SBICs have been a terrific vehicle, and it is just a crime if we are unable to take the good of the SBICs because of problems with one or two, or maybe it's 17, or maybe it's 117. I don't know. But there are an awful lot of good things going on with the SBIC industry and I think it is important that we get to the bottom of this so that we don't end up eliminating the entire program.

It seems to me that whatever it takes to get to the bottom of this, we have to move quickly on it.

Now, in this whole process, how was this, the EWE and the employees, how were these people identified? Did you find them? Did they come to you?

What is the process by which we got to where we are today?

Mr. **Gillum**. When I came on board with SBA in April 1987, one of my concerns was that all of our resources were going into doing licensee examinations. I visited my field office, I talked to our folks, and one of the things that I asked the field people out there is what would you do if you were me.

One young fellow up in Boston, who spent his whole career doing licensee audits, said that one of the most criminal things we are doing is spending all of our efforts doing licensee audits, taking them up to the time when we make a recommendation that they place them into liquidation, and then we ignore them and we never look at them again.

I came back and talked to my senior audit managers about that. I was told that the young fellow didn't know what he was talking about, that when they go into liquidation there is no real problem because they change from a licensee into something that has gone into receivership and the courts look at them and we're safe.

I was not satisfied with that. We cut out some resources and scheduled an internal audit, as opposed to a licensee examination, an internal audit of the portfolio management activities. It was just a kind of general, internal audit, the kind of thing you are familiar with that GAO does all the time.

In the course of that broad scope review of the liquidation activities, this EWE/Royal Business Funds matter surfaced. It became so staff-intensive, in terms of trying to find the records, to run down everything and spread it out, and it covered so many years, that we literally abandoned and put aside the initial review to do the broad scope review of that, and concentrated those audit resources in producing the report on Royal Business Funds/EWE.

We then were going back and were starting to pick up the audit of the overall portfolio thing when the Deputy Administrator advised me that if I would defer, the Agency would hire an outside, independent firm to come in and do an overall review of those activities—this discussion was going on in August of last year—and that they would have that work done by December 15.

I will admit to you that, as an IG person, and as auditors and investigators, any time anybody asks us to not do something, we, of course, become very suspicious. I was concerned about not proceeding.

But I also knew, deep down in my heart, that there was no way in the world that we were going to go in there and do our review and have it done by December 15.

So we had a long chat, the Deputy Administrator and I about that, and I expressed some concerns about the kind of companies they might get and the people they might get to do it, and so forth. After that, they engaged an outfit called Irving Burton and Associates, which is a graduated 8(a) firm, and they placed some conditions on Burton and Associates that they engage people who were not prior employees of the Agency and who were experts in the area and people who were not involved in the program.

They performed their review. They delivered a draft report to the Agency, I think by December 15, which is a real task. I think any audit manager in Government, including Chuck Bowsher, will tell you that getting audits completed in a timely manner, especially broad-scope audits, is a hard thing to do.

I will back up and say that what Burton and Associates did was not an audit. It was a consulting team review of the activity. They did not have to comply with General Accounting Office standards. That allowed them to do it a little more expeditiously.

But they did a fine job. They delivered that product, and this is sort of the background on it.

Senator KASTEN. So what you are saying to us is there could be several of these out there and we don't right now know about them, and that that particular audit would not have helped us find them, or maybe this is absolutely unique. It has to be pretty close to unique with regard to the SBA employees participating in forming the new company.

But the next step back from that is you could have some companies that are in a lot worse shape than you think they are right now, or you could have some of the kind of activities that are outlined in a couple of the newspaper articles and whatever, having to do with Hospital Trust, and River Capital, and the whole thing. I mean, there is this whole process and there could be some more of these.

The EWE element is the element that is likely to be unique.

Mr. GILLUM. Oh, clearly unique, as far as we are concerned. We have certainly seen nothing that would tell us that that, in itself, has been repeated.

By definition, the companies that are in liquidation are already problems for the Agency. I mean, that has already been decided.

Senator KASTEN. But it is difficult to decide whether those problems are simply failed business ventures or mismanagement, or mismanagement and maybe even illegal activity, which the Small Business Administration should be aware of and should be auditing and should be trying to follow up on.

I mean, obviously there are a lot of people who go into these venture capital businesses that do not make it, whether they are SBICs or whatever. This is a risky business, by definition.

Mr. GILLUM. Clearly, and anything we don't audit is a potential.

Senator KASTEN. But there has to be a role here for someone to look.

There is a group that represents the SBICs, called the National Association of Small Business Companies. Have you, in your experience—I kind of think of them as a trade association kind of group—in your experience, do they perform any of these kinds of overall judgments of the kind of quality of their members? Is there any industry-wide policing, if you will? Maybe "policing" is not the right words, but do you understand what I am saying? Are there association members working together here?

Mr. GILLUM. I am sure that the association, like most others, has a set of goals, and that they are lofty. It certainly would not be my expectation that I would put any great reliance on their policing activities because I think their basic objectives are somewhat different from mine, although their overall objective, I think, is to promote the best of the industry and that sort of thing.

The things that we are concerned about I think are how do we, as an Agency and as an Inspector General operation, best focus our resources to try to give coverage to these various activities.

Senator KASTEN. Mr. Chairman, I just want to repeat that I think SBICs are so good and so important and such an area that I think demonstrates future promise, that we have to figure this out in order that we can get back on the track in getting a whole group of them going in an aggressive kind of way.

Therefore, I am particularly pleased that we are having this series of hearings.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kasten.

Senator Grassley.

STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. First of all, Mr. Chairman, I would likewise insert my opening statement in the record at the appropriate point.

The CHAIRMAN. Without objection.

[The prepared statements of Senators Grassley and Dixon follow:]

STATEMENT OF SENATOR CHARLES GRASSLEY
SMALL BUSINESS COMMITTEE HEARING:
SBA'S SMALL BUSINESS INVESTMENT COMPANIES PROGRAM
MAY 9, 1990

Mr. Chairman:

Thank you for holding this hearing to give the Committee the opportunity to examine the problems which have been reported regarding the Small Business Investment Companies (SBICs) program.

I am very concerned about the failures of the two SBICs we will be discussing today--the River Capital Corporation and Royal Business Funds Corporation. Reports that together, these two corporations have defaulted on $46.5 million in SBA guaranteed loans, and that the delayed liquidation of Royal Business Funds Corporation asset's may ultimately cause SBA to lose an estimated $10 million, are very disturbing, in the very least.

Additionally, I am concerned about the health of the entire SBIC program. I believe that even the appearance of misuse of taxpayers dollars needs to be eliminated. Simply put, the SBIC program must act in a fair and equitable manner if it is to effectively meet its targeted goals. It is my hope that we be able to determine the cause of these problems and find a solution for these apparent inadequacies in the SBIC program.

I want to thank Inspector General Gillum for testifying before us today. I look forward to hearing your insights into this matter.

STATEMENT BY SENATOR ALAN J. DIXON
BEFORE THE COMMITTEE ON SMALL BUSINESS
ON PROBLEMS IN THE
SMALL BUSINESS INVESTMENT COMPANIES INDUSTRY

MAY 9, 1990

MR. CHAIRMAN, I AM DISTURBED BY THE GROWING NUMBER OF FAILURES OF SMALL BUSINESS INVESTMENT COMPANIES (SBICs). NEARLY THREE IN TEN INVESTMENT COMPANIES WERE, OR ARE CURRENTLY, IN LIQUIDATION -- NEARLY 30 PERCENT! THE AMERICAN PEOPLE PLACE A SACRED TRUST IN US IN GOVERNMENT TO PROTECT THEIR INTERESTS. TODAY, INSPECTOR GILLUM WILL TESTIFY ON TWO SBIC FAILURES WHERE THAT TRUST WAS VIOLATED -- AT CONSIDERABLE COST TO THE TAXPAYERS.

WE CANNOT CONTINUE TO ACCEPT EXCUSES FOR THE HIGH INCIDENCE OF SBIC FAILURES. WHILE THE MAGNITUDE PALES WITH RESPECT TO THE SAVINGS AND LOAN DISGRACE, SBIC FAILURES CAUSE CONSIDERABLE HARM TO AN IMPORTANT SEGMENT OF THE AMERICAN ECONOMY -- SMALL BUSINESS. I AM BESIEGED BY SMALL BUSINESS OWNERS WHO ARE FINDING THAT NEW CAPITAL IS DRYING UP AND EXISTING CREDIT LINES ARE BEING REDUCED OR CALLED DUE. OVER $560 MILLION IS POTENTIALLY AT RISK WITH THE 170 SBICs CURRENTLY IN LIQUIDATION -- MONEY THAT IS NEEDED TO FUEL A WEAKENING ECONOMY! UNFORTUNATELY, WE CAN EXPECT BOTH THE NUMBER OF FAILED SBICs AND THE POTENTIAL LIABILITY TO CONTINUE TO INCREASE IN THE NEAR FUTURE.

A THIRTY PERCENT FAILURE RATE IS SYMPTOMATIC OF A PROCESS THAT IS OUT OF CONTROL -- EXACTLY WHAT MR. GILLUM ALLUDED TO IN HIS TESTIMONY BEFORE THIS COMMITTEE ON MARCH 8 OF THIS YEAR. ROYAL BUSINESS FUNDS CORPORATION AND RIVER CAPITAL CORPORATION BOTH OFFER LESSONS TO BE LEARNED. WE MUST EXAMINE BOTH THE MECHANISMS THAT CAUSED THEIR DEMISE AND THE SYSTEMIC PROBLEMS WITHIN THE SMALL BUSINESS ADMINISTRATION THAT ALLOWED THESE TWO, AND OVER 170 OTHER SBICs TO FAIL. I WILL BE VERY INTERESTED IN THE PROCESS THAT MR. GILLUM AND ADMINISTRATOR ENGELEITER WILL UNDERTAKE TO GUARANTEE DRASTIC IMPROVEMENT IN THE PERFORMANCE OF THE SBIC PROGRAM.

I WOULD LIKE TO COMMEND THE CHAIRMAN FOR HOLDING TODAY'S HEARING AND I LOOK FORWARD TO THE TESTIMONY OF INSPECTOR GENERAL GILLUM.

Senator **Grassley**. I know you have made these 16 recommendations regarding SBICs and I have some questions about them. But, first—and I think this is unrelated to your 16 recommendations—what has been done by your department to insure that the other SBICs in liquidation are better handled than the liquidation of Royal Business was? By that I mean, what do you do right now to stop the bleeding?

Mr. **Gillum**. I think, in terms of the liquidation program, certainly following the issuance of the Royal Business Funds report, one of the things the Administrator did was to engage the study by Burton, and they produced a report and made several recommendations on how to improve those internal operations of the Office of Portfolio Management.

One of those recommendations was that they bite the bullet and provide some additional staffing in there so that the people running that operation can do a better job.

There is a series of other recommendations in that report, and I would not propose to sit here today and make a judgment on how well those are being carried out. It is certainly something that in the future, all things being equal, we will go back in and look at, and have our own auditors look at the activity and look at the Burton Report recommendations, and see what management did down the line to improve the operation and take corrective action.

But we have chosen not to do that right now because the report has just recently been done, the actions are being taken, and sometimes you have to leave the patient alone so that he can recover, rather than to keep cutting on him.

So I think they are moving in that direction, Senator, and it is encouraging.

Senator **Grassley**. They are being applied, then, to the other companies that are in liquidation?

Mr. **Gillum**. Yes, sir.

Senator **Grassley**. In other words, they are already over the hump, as far as the liquidation is concerned. The principles of that study you feel are being applied in all of the remaining liquidations?

Mr. **Gillum**. Yes. That is my understanding.

Senator **Grassley**. And that was the purpose of the study?

Mr. **Gillum**. Yes, sir. That's right.

Senator **Grassley**. So, from a management standpoint, you feel they have taken action to stop the bleeding?

Mr. **Gillum**. There is some real movement there and it looks very encouraging.

Senator **Grassley**. Now I don't know if this is in your area or is something that you, in your capacity, oversee. But what is being done to assist existing and functioning SBICs to help them avoid failure and eventual liquidation?

Mr. **Gillum**. Well, you are right. That is a question that would best be directed to the Investment Division folks.

Senator **Grassley**. But from your standpoint, do you think that there are programs in place? This is part of seeing that we don't get into this bad situation again.

Mr. **Gillum**. I think, clearly, that is one of the mission goals of the Investment Division, that they want to see these companies succeed. It is certainly not their intention to want to license them and then to run them into liquidation.

They have also, at times, in their FMFIA, the Federal Managers Financial Integrity Act submissions, made it clear that they have had resource problems and we believe that they need additional resources to help monitor the ongoing licensee efforts.

There, again, to their credit, the Administrator has ordered a study of that. A study was done. A number of recommendations were made. Again, it is my understanding that they are moving forward.

Again, I would not put a value judgment on how well their actions are until we get a chance to go and look at them. But at least it is encouraging right now, that they are moving in that direction. And they understand the problem.

Senator GRASSLEY. Are you always in a position of locking the barn door after the horse has been stolen, or isn't there someplace that in your capacity where when you see something wrong, even though you don't manage the program, can't you step in and, if you see a problem, point it out before it gets to the worst stage possible? Or is that beyond your capacity?

Mr. GILLUM. No, sir.

We certainly try to do that. As part of our overall operations, we look at regulatory changes that are being proposed in the Agency, at legislative proposals that are being made, internal operating procedures and those kinds of things. We look at those all the time to see if there is a possibility that there are any weaknesses in internal controls, and we make recommendations about those.

On a case-by-case basis, when we see problems, we try to extrapolate those from the whole as best we can. That gets into some dangerous territory, you know, taking one small example and trying to apply it to a whole industry.

But yes, we try to make some recommendations. Again, the problem that we have had is that our whole concentration over the last 10 years or longer has been on doing licensee exams. That is like learning the same lesson once a year, over and over again, and not having the ability or the institutional memory to step back, look at those in some aggregated fashion, and to draw some conclusions, some analytical conclusions from those.

We want to do some things like that, and we try. But a lot of what we do is clearly after the barn door is closed.

Senator GRASSLEY. I have a general question regarding your relationship with the Administrator and the administration, and not just this Administrator, although I suppose you have to consider the individual. My perception of Inspectors General, throughout the bureaucracy, is that they are about as welcome as a skunk at a Sunday school picnic.

Do you feel that, within SBA, you are well received, not just as an individual, but in the position of Inspector General, with the recommendations you make? Or are you always fighting the bureaucracy, trying to get your things through—the recommendations acted upon?

Mr. GILLUM. You've got a lot of questions in that question, sir. I think your characterization of it is very nicely put, probably cleaned up a lot. A "skunk at a party" is a lot nicer than other people have said.

We are in a very contentious, adversarial relationship. It is rocky at times across the board with the managers in the Agency.

Basically, we can get done what we can prove. If we want to get action, we tie it down by the numbers, we document it, we put the evidence up, we make our arguments, and we have to be compelling in what we want to do.

Senator GRASSLEY. That leads me to this—not to go through your 16 recommendations though, because this is just a short and final question: You stated that some of the recommendations have been followed by the Administrator. Do you assume that all 16 will eventually be implemented?

Mr. GILLUM. All 16 will be resolved or management decisions will be made with respect to them before we will close out the audit. I very carefully couch that because, to be quite truthful with you, there are individual instances where they come back with responses to some of our recommendations that we don't necessarily agree with. But that is their position and in some cases, you know, in past times, sometimes we think they are right and sometimes we don't think they are. But with the press of other things, sometimes it may not be worth it to keep up the fight on one particular item.

But all of those are in a system and there is a process to make sure each one is dealt with by management and there is a record of that. It is there before we close that matter out.

Senator GRASSLEY. Is there a process in place where you make recommendations, some are implemented and then the Administration says, "Well, you know, we don't think this is a very good recommendation?"

Do they try to persuade you and, at times you can be persuaded because then you have something brought to your attention that you didn't stop to think about?

Mr. GILLUM. Oh, clearly. Clearly. We always welcome, when we make recommendations, any manager who can come back with a better solution to curing the problem than what we have recommended. We would like to put it on the table and talk about it.

We don't have a lock on wisdom.

Senator GRASSLEY. In most cases, do you run into an attitude of receptivity and negotiation, or is it an attitude of, "We don't care who you are?"

Mr. GILLUM. Oh, it's across the board.

I had two very rewarding experiences here in recent times. We had a very bizarre audit that we did on a piece of what they call COLPUR, a piece of property that has been in inventory for about 10 years. No rents had been collected. The original owners were allowed to maintain use and possession of the property. The place was being used as an illegal chop shop and there were a number of other things wrong with it.

We did a report on that, and we took that to the Regional Administrator in New York, Charlie Freeman. Charlie moved on that very, very quickly. He not only moved on that one and got it into a situation where they sold it and got it out of the inventory, but he did a total review of his region. He found that he had a problem in a number of places, and in Puerto Rico in particular. They took some very aggressive actions to reduce the whole inventory.

To me, that was just basically heartwarming, if you will, to see that somebody, instead of fighting us on one particular one, took it and added it to their own agenda and went one step further and took some good actions.

We had a similar experience in Region 4 recently, where the Regional Administrator was doing a preferred lender audit. Some of the lower managers were not necessarily too happy with some of the recommendations. We took it up to the Regional Administrator and in this case she supported us to the wall and has taken very firm and aggressive action.

So it has been good. And it is a mixed bag.

Senator GRASSLEY. Thank you, Mr. Gillum.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

Mr. Gillum, there was a gentleman who worked in the IG's office named Lapato—L-A-P-A-T-O. He did a report on the Arthur Andersen audit of River Capital Corp. Was it in November 1988?

Mr. MCCLINTOCK. That's when the initial draft was submitted. Yes.

The CHAIRMAN. Now, as you know, Mr. Lapato is the one who has said that your office tried to cover up Arthur Andersen's negligence or culpability or whatever you want to call it in their audit of River Capital Corporation. And apparently that was based on the proposition that your office handed Arthur Andersen a copy of his report.

True?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. Now I am not in a position to judge whether or not it was proper for you to give Arthur Andersen a copy of that report or not. Frankly, I don't find much wrong with it. After all, they are the ones who issued the audit, and if the IG's office found that it was seriously deficient and sets out the reasons why, I think they are entitled and I always believe in the accused having a chance to defend himself. So I don't find anything terribly culpable about that.

Now, I have not seen his draft report, but we have it. Unhappily, I did not get it in time to read it before this year. But we will pursue this issue further, as I have said.

Since that time, he has retired. Is that correct?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. Now, did he retire because he was upset about this, or do you know?

Mr. GILLUM. I think it was a combination of things.

The CHAIRMAN. He was ready to retire and he was upset, both?

Mr. GILLUM. I think so.

I would like also to mention that Mr. Lapato was the gentleman who steered me on to the fact that we were blindly following licensee examinations up to the point of liquidation and dumping those companies into a black hole and walking away from them at the point of the Government's greatest liability.

The CHAIRMAN. I'm not following you. Say that again.

Mr. GILLUM. As you will remember, earlier I talked about a gentleman up in Boston pointing out to me when I first came on board that one of the stupidest things we did was concentrate all of our activities on licensee audits and then take them up to the point of liquidation and then forget about them from then on, and that we should be looking at those things in liquidation.

Mr. Lapato is the one who told me about that, who planted that notion with me and steered me on to getting that audit started, to look at that overall activity. So Mr. Lapato is endeared to me in that regard.

With respect to the cover-up issues and providing a report——

The CHAIRMAN. Well, is the allegation of a cover-up based solely on the proposition that you gave Arthur Andersen a copy of the audit?

Mr. GILLUM. I don't think so. I think that was part of it. I think another part was too long a time going by in terms of issuing something or doing something, of which Mr. Lapato was part of the problem.

Let me address the issue of providing Arthur Andersen the report.

The President's Council on Integrity and Efficiency, a body that is set up within the executive branch by the President, of which all Inspectors General are members, has some procedures and guidelines that we promulgate among ourselves. One of the procedures that they have, the standards that they have promulgated, deals with handling and operating in environments where you find you have substandard work performed by independent public accountants.

One of the things that those standards say clearly is when you find that, go to that firm and get their written comments on what they have done. We did that. Other agencies do that. It is a very common practice to provide copies of draft reports to people that are mentioned in the report or the auditee.

GAO does it all the time.

There was some concern in the Agency expressed about how by providing that we might have jeopardized the Agency's ability to litigate properly on behalf of the Government, and so forth, and to the degree that that might be true, I would find it distressing. But the rest of the Government lives with that kind of process all the time.

Years ago, I worked at HUD and Pete McClintock worked at HUD. We used to literally refer hundreds of what we considered to be cases of insufficient work by IPAs over to the Standards Committee of the AICPA. When we got this case in, this audit work that Mr. Lapato had done, that was the first thing on our minds and it was a given that we were going to do—at some point or other, given that other decisions were made about litigation or other things that might be of interest to the Government—that we were going to refer this to the AIPCA and let them wrangle it out.

The CHAIRMAN. What action, if any, did Arthur Andersen take after you sent this report to them? Did they contact you?

Mr. GILLUM. Pete went and met with them.

Pete, why don't you jump in here.

The CHAIRMAN. What does it mean when you say "networked them?"

Mr. GILLUM. No, sir, met with them.

The CHAIRMAN. Oh, met with them.

Mr. MCCLINTOCK. They contacted us. Steve Switzer, Dan Peyser, our attorney, and I met with Arthur Andersen. They explained their position.

They pointed out in the report certain areas where they believed we were mistaken. They invited us back to re-review the audit work papers and they believed we had overlooked some documents, which, really, Mr. Lapato had not overlooked. But they were of that opinion.

The CHAIRMAN. Pete, let me address this question to you.

What action did you take so far as this report was concerned after you met with Arthur Andersen?

Mr. MCCLINTOCK. Well, I requested Mr. Lapato to incorporate the audit standards that were violated into the finding and to rewrite the finding so that the analysis would relate to the audit standards that were violated.

I received a draft from——

The CHAIRMAN. Did his report not specify the audit procedures or principles that had been violated, or allegedly violated by Arthur Andersen?

Mr. MCCLINTOCK. It did not contain any of the generally accepted audit standards that were violated. It did refer to other AICPA guidance. But it did not have the audit standards.

The CHAIRMAN. So you asked him to go back and incorporate that into the report?

Mr. MCCLINTOCK. Correct.

The CHAIRMAN. What did he say?

Mr. MCCLINTOCK. Oh, he did. He incorporated them. I think he incorporated six standards. All he did was quote the standard, place it in the report, and did not perform any of the analysis to relate the work that was done or not done to the standards that were violated.

The CHAIRMAN. So all he did was to just list the standards?

Mr. MCCLINTOCK. That's correct.

The CHAIRMAN. And he didn't say how Arthur Andersen had violated those standards?

Mr. MCCLINTOCK. That's correct.

The CHAIRMAN. Now, as I say, I have not seen a copy of that report. Apparently, he was irritated enough to go maybe to the FBI or CNN and other people and so-called "blow the whistle" on the so-called cover-up. Is that your understanding?

Mr. MCCLINTOCK. Well, the first understanding I had of a cover-up was when the General Accounting Office visited our office. I believe somebody, Mr. Lapato perhaps, but somebody contacted GAO and advised them that we were trying to cover up some substandard work by a CPA firm.

The CHAIRMAN. What did GAO ask you?

Mr. MCCLINTOCK. They reviewed the record. They reviewed the draft reports.

The CHAIRMAN. Including his report?

Mr. MCCLINTOCK. Yes, sir.

The CHAIRMAN. What did they conclude?

Mr. MCCLINTOCK. Well, I believe they talked to Mr. Gillum and concluded that there was no coverup. They also advised him that the initial draft reports were not of the best quality and they understood why we wanted to produce a quality report.

The CHAIRMAN. So, they essentially took your side and against Mr. Lapato's position?

Mr. MCCLINTOCK. That's my understanding.

The CHAIRMAN. Now, GAO did a report on the IG's office and these audits back in November 1988, did they not?

Mr. GILLUM. That was of SBA, HUD, and the Department of Agriculture.

The CHAIRMAN. Who had requested that GAO study?

Mr. GILLUM. I think that was just self-initiated.

The CHAIRMAN. You think they did it?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. Now, their report, which I have looked at, points out that in fact the kinds of audits you are getting, such as the Arthur Andersen audit, are seriously deficient in telling the Small Business Administration and your office whether a company is viable or is not viable.

Is that correct?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. My question is what changes have you made in your auditing procedures as a result of the GAO report? Any?

Mr. GILLUM. Well, there are two things there. One is we have to change the way we look at the work being done by the CPAs, and we have also changed some of our own work. The changes that we made to our own work were basically self-initiated because, when Mr. McClintock's predecessor came on board, Steve Switzer, of my concern that we weren't complying with the auditing standards.

Now the GAO report did not review our audit work. What they were reviewing were the kinds of work done by the Arthur Andersen company.

The CHAIRMAN. That is my understanding. And they said you are not going to get the kinds of information that will be helpful to you in determining whether these companies are viable are not, whether they are healthy or not, unless you do a much greater, in-depth audit than the ones you are requiring now.

Isn't that essentially what they said?

In other words, they said instead of just saying we complied with the general accepted accounting principles, they have to go behind the documentation. They have to look at the underlying documentation, do a sort of regulatory audit, before you are going to find out whether that company is really doing well or not. Isn't that essentially it?

Mr. GILLUM. That's right. That's what I spoke about earlier, when they said that the accounting firms should be operating under the generally accepted Government auditing standards. That would require the testing for compliance and then the reporting on compliance activities of the auditee.

The CHAIRMAN. Now, Mr. Gillum, my question of you is this. Since you do a biennial audit of these SBICs, have you been doing those audits in accordance with the recommendations of GAO since that time?

Mr. GILLUM. That's what I'm trying to explain, Senator. There are two different things.

The work done by the independent public accountants, the Arthur Andersens, the licensee in this case, the SBIC, is required by law and regulation to engage an independent public accountant to do a financial audit. And they do that. They do it on an annual basis.

When we do our biennial review, it is a compliance type of review in which we audit against what they call the "Big Six" regulatory items of the Agency. We audit against those activities. They are a little bit different.

The focus of the CPAs is financial, and they should be reporting on some compliance, too. Ours is almost entirely on compliance.

Now, when Steve Switzer came on board, one of the practices in place that was very troublesome to me was that when we did our own work, we had an agreement with management that we would not make independent conclusions or put recommendations in our report. Well, that goes to the very heart of what the Comptroller General says we are supposed to do in order to have independent audit work.

And so, we started doing that. It adds a little time to what we do, but it certainly provides for a more thorough product.

What we have to do in addition is what I talked about before, and that is we have to get some talent on board that has some CPA background to set up a Quality Assurance Review Program, so as each of those annual audits are being performed by SBICs and they come in, we can review them more thoroughly in a centralized fashion against established criteria and have some uniform view of what is going on out there in the industry and not rely on the individual auditors out there making judgments about the quality of the audit work being performed by CPAs.

The CHAIRMAN. Did the Agency make any requirements of changes in the kinds of audits that they would accept?

Mr. GILLUM. No.

We have a proposal in for discussion purposes in the form of a Revised Audit Guide for CPAs to do SBIC audit work.

The CHAIRMAN. But those have not been implemented?

Mr. GILLUM. No, sir.

The CHAIRMAN. So, 1½, almost 2 years after RFC goes under, your office says that Arthur Andersen was negligent, or certainly sloppy, and not sufficient to really give you a good feel for that company, 2 years later we still have not corrected that problem?

Mr. GILLUM. That's correct.

The CHAIRMAN. Mr. Gillum, who is responsible for that? Who would you pin the blame on for that?

Mr. GILLUM. Well, I guess it comes to me because the Inspector General Act of 1978 says that the Inspector General will set auditing standards and provide for quality assurance of audit work.

The CHAIRMAN. Now I have read this internal memo from Steve Switzer to Eric Benderson. Steve Switzer was your assistant. It is to Eric Benderson, Associate General Counsel, Office of Litigation, dated January 25, 1990. And you look through that and you look at the points he makes about the Arthur Andersen audit—and as I say, we will hold a hearing later and get more deeply involved in that.

But one of the things, for example, they listed a company, one of the 40 companies that River Capital had invested in. Their stock was selling for 2 cents a share. River Capital owned about 3.5 million shares in that company, and it was selling for 2 cents a share. This meant that their investment at that time was worth $73,000. And yet, that investment was listed as being worth on River Capital's books, what was it, $3 million or $3.5 million? What was it?

Mr. McClintock. I believe it was in the $1 million range.

The Chairman. A million? A little over $1 million.

Mr. McClintock. Right. Correct.

The Chairman. I'm thinking about another one. It was a little over $1 million. But it is just as plain as the nose on your face that the stock in that company is worth $73,000 if you sell it all in the same day.

And here, 2 years after the fact, we still have not done anything.

And yet, Mr. Gillum, you objected a moment ago to me saying that we ought to go at this not on a shotgun basis, and a very orderly way, of hiring outside counsel. But you don't have the manpower to do it. You know that. Don't you?

Mr. Gillum. That's true.

I wish you wouldn't put it in terms of "I object." I was just trying to offer a different approach.

The Chairman. Well, let's get the record straight, then. What is your approach?

Mr. Gillum. My approach, as we tried to outline, is we want to get the regulatory change inside the Agency. We want to get the new standards promulgated in regulations, change from GAAS to GAGAS, as the General Accounting Office has recommended. We want to have our Quality Assurance Program in place so that we can review all of the work that is being done by them as we go along on a uniform basis. We want to get relief from the biennial requirement so that we can take a criteria based planning approach to doing SBIC work on a regular basis, and I think management needs to have some more resources to do monitoring activity. I think, when you put that all together, it adds up to an adequate program.

The Chairman. Mr. Gillum, that sounds to me like a lot more comment period and all those things that bureaucrats go through and nothing ever happens. But we have a crisis, so far as I am concerned, that is immediate.

As Chairman of this Committee, I don't want to sit here and have people ask me where were you when all of this took place and what are you doing about it.

Mr. Gillum. I think your point about the bureaucratic stuff is well taken, and I am frustrated by it myself. I would like to point out that, while I am responsible for setting audit standards and quality assurance of audit work within the Agency, I don't own the Agency and I don't own the Agency systems of regulations. I have to work within that. That is what we are trying to do.

In the meantime, we are moving out on our own because we are not waiting for those things to happen. There are some differences of opinion about some of these things within the Agency.

But I think my responsibilities are sufficiently clear under the Inspector General Act, and in order to do that, I am moving forward and I am applying resources as best we can to priority areas, as they are defined. That is going to be in other areas, other than licensee examinations at times.

In addition to that, we have expanded our coverage so that we are looking more attentively now to the valuation methodology being applied by licensees when they submit their CPA reports and when we are doing our own reviews.

We have changed our own audit approach to comply with the General Accounting Office audit standards. Those are things that we can do.

As we set up our Quality Assurance Review Program, we are going to be going back to these firms around the country, as we review their reports, and we are going to tell them that we expect to hold them to GAGAS, regardless of what the regulations require.

The reason we are going to take that approach is, one, when they do Government accounting work, GAO has said—and GAO sets the standard Government-Wide for auditing work—GAO has said they have to comply with GAGAS. And one of the things is that, in my view, they cannot water down their coverage and avoid the standards by pointing to an audit guide or something else that would relieve them of those responsibilities.

So we are moving forward on a number of fronts to try to deal with some of these problems regardless of whether those regulations are implemented or changed.

The CHAIRMAN. I'm looking at a response here which I think was probably given by Senator Abdnor to the GAO report which concludes, "Thereafter, the Inspector General was advised that such audits"—that is, the audits recommended by GAO—"would substantially increase CPA costs and billings. Given that experience, we have difficulty with GAO's position. However, the Inspector General is willing to revisit this issue in an attempt to test the feasibility of the recommendations. We may seek GAO's assistance. In any event, we will provide you with a report."

Mr. GILLUM. I think we need to go back. Let me go back to the original report, GAO report. There is a letter there from Senator Abdnor responding to that report. I think it is dated December 17, and it is attached to the GAO report.

This is one of those situations where, even as a bureaucrat, you cannot afford to go on a vacation or take leave. For the first time in 10 years, I took a 2 week leave. I took my wife and we went to Hong Kong and to China. I came back and that December 7 letter had been staffed and processed out the Agency.

I do not agree with the position that is stated in that. I think it is wrong. You will find, if you review the text of the GAO report, even though Senator Abdnor's letter is attached, that they don't agree with it, either.

They, as a courtesy, attached the letter, as they do all the time. But they dismissed those arguments totally. Their position is clear.

I agree with their position. The subsequent thing that I think you are probably reading from there in some kind of abstract or outline form is something that was done subsequently to try to signal to GAO that we were going to go ahead and try to comply with their report as best as possible.

That is sort of the background.

The CHAIRMAN. Mr. Gillum, the GAO recommended: "Insure that agencies have controls for reviewing audit quality." Here is SBA's comments on that. "We are not in complete agreement with GAO, as all annual financial statements submitted by CPAs are currently being reviewed and analyzed by the Program Office. Any anomalies, questions, or apparent errors are fully tracked down. In addition, the work of the CPAs is reviewed during the Inspector General's compliance examination of the audited entities. Based on reviews and tests made over the years, the Inspector General has found no pattern of substandard performance by CPAs. Nevertheless, the Inspector General agrees that it would be useful to review the OIG's procedures with a view toward centralizing this function to provide for (1) timely referral and followup on substandard work; (2) greater uniformity and consistency."

Now, to summarize that, I am not going to suggest that there has been a pattern of laxness on the part of the CPAs. But I suggest this. We have a report from Arthur Andersen on River Capital saying they are just in great shape in December 1987, and 6 months later they are in liquidation, and we are going to lose about $24 million of our investment there. I have to tell you, in all fairness that an honest statement is that that audit would never have been suspect if River Capital had not gone under.

Mr. GILLUM. Under the way it has operated in the past, I think that is true. That is not going to happen in the future.

The CHAIRMAN. How many auditors did you have in 1981, or how many were there in the SBA and in the IG office in 1981?

Mr. GILLUM. Without checking, I'm not real sure, sir.

The CHAIRMAN. How long have you been IG?

Mr. GILLUM. Since April 1987.

The CHAIRMAN. How many were there when you went there?

Mr. GILLUM. There were about 67.

The CHAIRMAN. So you have 10 fewer now than you had when you went there?

Mr. GILLUM. Ten or 12, yes.

The CHAIRMAN. I would like you to supply for the record how many were in that office in 1981.

Mr. GILLUM. Certainly.[1]

The CHAIRMAN. Now, have you gone and looked at other audits, for example that Arthur Andersen has done, of other SBICs since this whole thing came up in November, essentially, of 1988?

Mr. GILLUM. I don't believe so.

The CHAIRMAN. Do you know how many other audits Arthur Andersen has done on other SBICs in the past two years?

Mr. GILLUM. No, I don't.

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[1] Answer appears on page 28.

The **Chairman**. But this did not cause you enough concern to cause you to look at their other audits to see whether we have any other 2-cent stocks out there?

Mr. **Gillum**. I think that is a real good question. It is certainly something that is worthwhile to do.

Steve reminds me that the Agency is looking at that as part of the action that is under review.

This is not to alibi, but I think that is a super question and is something I would really be interested in. But it is like the old thing about draining the swamp and running from the alligators. That is part of what we have been doing.

The **Chairman**. And that's what we are going to do. We are going to drain the swamp and find the alligators.

Can you tell me whether or not there are any other EWEs out there that are handling some of those 170 liquidations?

Mr. **Gillum**. We don't believe so, sir.

The **Chairman**. Steve, I thought you were nodding yes.

Mr. **Marica**. No, sir, I wasn't. We don't know.

The **Chairman**. You don't know.

Mr. **Marica**. We don't know. There has been no identification of any SBA employees that formed other corporations in any of the investigations that we have conducted. Certainly, in looking into the EWE thing, there has been no evidence that they tried to do that when liquidating other SBICs.

The **Chairman**. Well, I think that just about concludes what I want to ask for the record here. We will probably submit a few questions for the record.[2]

Our second hearing on this is going to be next Wednesday at 2. The Committee will stand in recess until then.

Thank you very much, gentlemen.

[Whereupon, at 11:50 a.m., the Committee recessed, to reconvene subject to the call of the Chair.]

SBA'S SMALL BUSINESS INVESTMENT COMPANIES PROGRAM

WEDNESDAY, MAY 16, 1990

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 2:08 p.m., in room SR-428A, Russell Senate Office Building, Hon. Dale Bumpers (Chairman of the Committee) presiding.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

The CHAIRMAN. This afternoon the Committee will begin its second hearing on the Small Business Investment Company Program with particular focus on the collapse of River Capital and the liquidation of Royal Business Funds Co. Last week the Committee heard testimony from Inspector General Charles Gillum and his staff. Today the Committee looks forward to hearing from the Finance and Investment Program managers of SBA who are responsible for management of the SBIC Program and liquidation of failed SBICs.

Representing the Administration will be Mr. Bob Lineberry who heads the SBIC Program; Mr. Earl L. Chambers who directs the Office of Portfolio Management; and Mr. Eric Benderson who is the Associate General Counsel for Litigation.

I have reviewed the legal memorandum prepared by the General Counsel in response to the IG's draft report on Royal Business Funds which found serious deficiencies in the conduct of the liquidation by EWE Properties, Ltd., which was a corporation established by SBA.

The General Counsel argues that the Corporation Control Act does not apply to EWE Properties because the act only applies to "Government Corporations," including certain corporations enumerated in the act such as the Federal Crop Insurance Corp. This argument that EWE was not a Government corporation, notwithstanding that SBA was the sole shareholder of EWE and that SBA employees were the only directors of EWE, is specious at best. This argument is what law professors like to call a false dichotomy. Clearly, any corporation established by a Government agency is a Government corporation in the plain meaning of the statute.

The Counsel also argues that the Small Business Act gives the Administrator power to "take any and all actions determined by him to be necessary and proper or desirable in making, servicing, compromising, modifying, and so forth." To assert that this broad delegation of authority authorizes the Administration to do things otherwise prohibited by law is erroneous.

I will add that I agree with the Counsel's position that SBA's efforts to develop properties such as those held by Royal are legally permissible if undertaken by SBA directly. While the Inspector General has questioned the business judgment shown in these expenditures and asserted that they may have resulted in further losses, I agree that the Administrator has authority to take such actions as necessary to maximize SBA's return from assets such as these.

Such actions, however, clearly do not include those things which are otherwise prohibited by law or which pose serious conflicts of interest for SBA and its employees. In this connection, I will have a number of questions for today's witnesses.

I hasten to add that the purpose of these hearings is not only to examine what went wrong in these two particular cases, bizarre as they seem, but primarily to determine the extent of programmatic problems so that the Committee can develop legislative remedies that may be needed. In a future hearing the Committee will invite Administrator Engeleiter to give her views both on regulatory and legislative changes which may be appropriate.

Senator Grassley.

Senator **Grassley**. I would like to put my opening statement in the record.

[The prepared statement of Senator Grassley follows:]

STATEMENT OF SENATOR CHARLES GRASSLEY
SMALL BUSINESS COMMITTEE HEARING
SMALL BUSINESS INVESTMENT COMPANIES
MAY 16, 1990

Mr. Chairman:

Thank you for holding this additional hearing regarding the SBA's Small Business Investment Companies (SBICs) program.

As I stated during our May 9th hearing, I am very concerned about the failures of the River Capital Corporation and the Royal Business Funds Corporation, as well as the over-all health of the SBIC program. I believe that it is necessary to maintain the SBIC program and ensure the integrity of this important program.

I hope that this hearing will shed more light on the problems experienced by the SBIC program. I know that it is the Committee's goal to identify the causes of these problems and eliminate them.

I look forward to the testimony of our witnesses and want to thank them for being with us today.

The CHAIRMAN. Senator Lieberman.

STATEMENT OF HON. JOSEPH I. LIEBERMAN, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator LIEBERMAN. Mr. Chairman, I have an opening statement which I would like to put into the record. I would just briefly say that I thought the hearing last week was troubling. Basically we have a program here that looked to me like a good program—it certainly started with good motivation—but something has gone wrong. I keep going back to the numbers. We are facing a situation at where 170 SBICs have failed and represent a potential exposure for the taxpayers in excess of $½ billion.

The Inspector General testified last week that of the 404 SBICs presently in operation, almost 20 percent represent what he would consider to be an above-average risk, and that 14 are presently being investigated by the Justice Department. So, this is a program, though well-intentioned, that has run amok. I hope that we can work together to make it better.

I share your concerns about the EWE case. I thought that the allegations made by the IG in that case were riveting and very troubling. I hope we will have some response to those today.

Thank you Mr. Chairman.

[The prepared statements of Senators Lieberman, Dixon, Boschwitz, and Lott follow:]

STATEMENT OF
SENATOR JOSEPH I. LIEBERMAN

SENATE COMMITTEE ON SMALL BUSINESS
HEARING ON SMALL BUSINESS INVESTMENT COMPANIES

Wednesday, May 16, 1990

Mr. Chairman, Thank you for calling this second hearing on the health of the Small Business Investment Company industry with particular focus on two recent and quite costly failures, River Capital Corporation and Royal Business Funds Corporation.

I don't meed to mention the critical role Small Business Investment Companies can play in our economy, particularly in light of a recent tightening of credit for small firms. S.B.I.C.'s, with their financial and technical expertise, offer small businesses the opportunity for venture or seed capital they would otherwise have no ability to secure individually or through conventional lending institutions. When successful, S.B.I.C.'s bring high risk products and services to the market at a relatively low risk and cost to the government or the economy.

Recent reports, however, suggest that something in the program has gone wrong. We are now facing a situation where 170 S.B.I.C.'s have failed and represent a potential exposure for the government and the taxpayers in excess of $500 million. Additionally, last week, we heard Inspector General Charles Gillum testify that of the 404 S.B.I.C.'s presently in operation, 19% represent an above average risk, and 14 are presently being investigated by the Justice Department.

Perhaps, even more troubling, was that Mr. Gillum and his colleagues were at an inability to gauge for us the overall health of the program. Their only industry-wide information was based on independent audit reports. As we heard last week, however, there seems to be some question as to the dependability of these reports. Mr. Gillum testified that, in the case of River Capital Corporation, the deficiencies in their accounting practices were "not appropriately identified and reported upon by the firm that performed River Capital's annual financial audit".

As I listened to the testimony and reviewed the audit reports, I could not help but conclude that there are shortcomings in S.B.A.'s oversight of existing program participants and the liquidation of failed ventures. It is my understanding that the S.B.A. has only 7 staff members, including one part time secretary, to handle the liquidation of over 170 S.B.I.C.'s with over 1,000 equity investments. The cases of both Royal and River Capital clearly illustrate these shortcomings.

Finally, Mr. Chairman, the Inspector General's report makes some very serious allegations about the establishment and operation of EWE corporation, a wholly owned S.B.A. corporation which was set up by three Small Business Administration employees. According to the I.G.:

1) "EWE corporation was not authorized by law and allowed other Treasury fiscal laws and Federal regulations to be circumvented".

2) "The development of a ski resort and a property in Florida by EWE will lose an estimated $11 to $15 million".

3) "EWE operation included actions and relationships which created conflicts of interest or the appearance of conflicts".

4) "EWE did not properly account for all liquidation funds".

5) "S.B.A. top management was not adequately informed of EWE's existence until recently".

Mr. Chairman, whether technically legal or not, when three Small Business Administration employees set up a wholly owned corporation, develop a ski resort and a Florida property, and circumvent Treasury Department and Regulatory liquidation procedures, with only scant accounting records, it raises serious policy and supervisory questions about the program.

Again, Mr. Chairman, thank you for convening these very important hearings, and I look forward to the testimony of Mr. Crusto, Mr. Lineberry, and Mr. Chambers.

STATEMENT BY SENATOR ALAN J. DIXON
BEFORE THE COMMITTEE ON SMALL BUSINESS
ON PROBLEMS IN THE
SMALL BUSINESS INVESTMENT COMPANIES INDUSTRY

MAY 16, 1990

MR. CHAIRMAN, LAST WEEK'S HEARING WITH INSPECTOR GENERAL GILLUM POINTED OUT SEVERAL SHORTFALLS IN THE AUDITING PROCEDURES CONCERNING SMALL BUSINESS INVESTMENT COMPANIES (SBICs). WHILE THESE AUDIT PROBLEMS ARE TRULY SIGNIFICANT AND MUST BE CORRECTED, THEY DO NOT ADDRESS THE ROOT CAUSE OF SBIC FAILURES -- THE BEWILDERING TENDENCY OF MANY SBICs TO BACK MORE LOSERS THAN WINNERS.

I FIRMLY SUPPORT THE SBIC CONCEPT OF PROVIDING FINANCING OF LAST RESORT TO MODERATE AND HIGH RISK BUSINESS VENTURES. OVERWHELMING SUCCESSES SUCH AS NIKE, FEDERAL EXPRESS, AND APPLE COMPUTERS ATTEST TO THE VALIDITY OF THIS CONCEPT. UNFORTUNATELY, IT APPEARS THAT THESE SUCCESSES ARE THE EXCEPTION AND NOT THE RULE. THE FAILURES OF ROYAL BUSINESS FUNDS CORPORATION AND RIVER CAPITAL CORPORATION IN ADDITION TO OVER 170 OTHER SBICs CURRENTLY IN THE LIQUIDATION PROCESS POINT OUT THE INCREASING DOWN SIDE OF SBIC OPERATIONS.

IN REVIEWING MR. HERTZBERG'S TESTIMONY I FIND THAT IT ONLY REINFORCES THE SHORT-SIGHTED ATTITUDE OF THE SBA WITH RESPECT TO SBIC FAILURES -- THAT OF AVOIDING BLAME INSTEAD OF

ADDRESSING ROOT CAUSE PROBLEMS. WHILE A SOLID AUDIT PLAN IS ESSENTIAL TO ENSURE THE INTEGRITY OF THE PROGRAM, OUR GOAL SHOULD BE TO PROVIDE THE MOST SUCCESSFUL BUSINESS VENTURES WITH THE CAPITAL AVAILABLE. TO ACCOMPLISH THIS GOAL, THE SBA MUST TAKE A MORE PROACTIVE ROLE IN ESTABLISHING SOLID PRACTICES AND PROCEDURES FOR THE SBICs IN ORDER TO GUARANTEE A BETTER INVESTMENT SELECTION PROCESS. WE CANNOT EXPECT EVERY INVESTMENT TO SUCCEED, BUT ONLY THROUGH MORE PRUDENT SELECTION OF INVESTMENT OPPORTUNITIES CAN WE ENSURE THE CONTINUANCE OF SMALL BUSINESS INVESTMENT PROGRAMS.

I ALSO VIEW THE OVERALL SBIC HEALTH ASSESSMENT FIGURES WITH SCEPTICISM AFTER LAST WEEK'S TESTIMONY BY INSPECTOR GENERAL GILLUM. I AGREE WITH THE CHAIRMAN THAT WE MUST ESTABLISH A BASELINE WITH RESPECT TO THE REAL FINANCIAL CONDITION OF THE SBIC PROGRAM. THIS SENATOR WILL NOT SUPPORT ANY FURTHER EXPANSION INITIATIVES UNTIL THE SBA PROVIDES THIS COMMITTEE WITH THE TRUE FISCAL EXPOSURE AND A PLAN ON HOW IT WILL IMPROVE THE PERFORMANCE OF SBICs.

I WOULD LIKE TO COMMEND THE CHAIRMAN FOR HOLDING THIS SECOND HEARING ON PROBLEMS IN THE SBIC PROGRAM AND LOOK FORWARD TO MR. HERTZBERG'S THOUGHTS ON IMPROVING THE SUCCESS RATES OF SBICs.

STATEMENT OF SENATOR RUDY BOSCHWITZ
HEARING ON THE
SMALL BUSINESS INVESTMENT COMPANY PROGRAM
SMALL BUSINESS COMMITTEE
MAY 16, 1990

THANK YOU, MR. CHAIRMAN, FOR HOLDING THIS SECOND HEARING CONCERNING THE FINANCIAL CONDITION OF THE SBA'S SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM. AS YOU KNOW, LAST WEEK WE HEARD FROM INSPECTOR GENERAL (IG) CHARLES GILLUM REGARDING PROBLEMS IN TWO SBICS IN PARTICULAR -- RIVER CAPITAL CORPORATION (RCC) AND ROYAL BUSINESS FUNDS CORPORATION (RBFC). FRANKLY, MR. GILLUM'S TESTIMONY WAS VERY DISCOURAGING.

AS YOU WILL RECALL, RCC HAS DEFAULTED ON $28.5 MILLION IN SBA GUARANTEED DEBENTURES, OF WHICH ONLY $2-4 MILLION MAY BE RECOVERED. THE IG BELIEVES RCC UTILIZED QUESTIONABLE ACCOUNTING PRACTICES. OVERDUE INTEREST WAS NOT WRITTEN OFF, AND WAS CONVERTED INTO SECURITIES INSTEAD. FURTHER, IT APPEARS THE VALUE OF RCC'S INVESTMENTS WERE INFLATED. ARTHUR ANDERSEN WAS RCC'S ACCOUNTANT, AND IT IS ALLEGED THEY PERFORMED SUBSTANDARD AUDITING WORK.

IN THE CASE OF RBFC, WE LEARNED OF ITS QUESTIONABLE CONNECTION TO EWE PROPERTIES LTD. (EWE). EWE WAS ESTABLISHED FOR THE PURPOSE OF LIQUIDATING RBFC'S ASSETS. ALL OF ITS PREFERRED STOCK IS HELD BY THE SBA, AND THE OFFICERS OF THE COMPANY ARE SBA EMPLOYEES.

THE IG BELIEVES EWE WAS FORMED IN VIOLATION OF THE GOVERNMENT CORPORATION CONTROL ACT; THUS, EWE IS AN UNAUTHORIZED GOVERNMENT CORPORATION CONDUCTING SBA FUNCTIONS IMPROPERLY. IT HAS ALSO DETERMINED THAT EWE RELATIONSHIPS WITH SBA OFFICIALS AND HIRED CONSULTANTS FORMERLY ASSOCIATED WITH RBFC OR ITS PRESIDENT CREATED THE APPEARANCE OF CONFLICTS OF INTEREST. IN ADDITION, EWE MAY HAVE COST SBA OVER $11 MILLION; AND IN A MOST DISTURBING REVELATION, WE LEARNED THAT EWE DID NOT KEEP ADEQUATE RECORDS AND SBA MANAGEMENT MAY NOT HAVE PROPERLY MONITORED RBFC'S LIQUIDATION.

MR. CHAIRMAN, I HAVE HEARD RUMBLINGS THAT SEVERAL OTHER SBICS MAY BE GOING UNDER AND CAUSING LARGE LOSSES TO SBA. IT IS VERY TROUBLING TO LEARN OF THE POSSIBLE EXPOSURE TO THE FEDERAL GOVERNMENT IF OTHER SBICS DEFAULT ON THEIR SBA DEBENTURES. WHAT I FIND MOST REMARKABLE IS HOW LITTLE THE SBA SEEMS TO KNOW ABOUT THE CONDITION OF THE SBICS THAT ARE IN LIQUIDATION. WE MUST FIND OUT WHAT CAN BE DONE TO PREVENT ANY MORE RIVER CAPITAL OR ROYAL BUSINESS SITUATIONS.

I LOOK FORWARD TO THE TESTIMONY OF MR. CRUSTO, MR. LINEBERRY AND MR. CHAMBERS THIS AFTERNOON. HOPEFULLY, THEY CAN SHED SOME LIGHT ON THIS VERY SERIOUS PROBLEM WE ARE FACING. THANK YOU, MR. CHAIRMAN.

STATEMENT FOR SENATOR TRENT LOTT BEFORE THE SENATE SMALL BUSINESS COMMITTEE HEARING ON SMALL BUSINESS INVESTMENT COMPANIES

MAY 16, 1990

MR. CHAIRMAN:

THANK YOU FOR HOLDING THIS HEARING, TO FOLLOW UP ON THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM. IN PARTICULAR, I KNOW THAT SOME MEMBERS OF THIS COMMITTEE HAVE A CONCERN WITH SBA'S MANAGEMENT OF THE SBIC INDUSTRY AND SPECIFICALLY ITS LIQUIDATION PROCESS.

THERE IS NO DOUBT THAT THE TWO SBIC FAILURES WHICH WERE THE FOCUS OF LAST WEEKS HEARING POSE SOME SERIOUS QUESTIONS AS TO THE PAST MANAGEMENT AND OVERSIGHT ABILITIES OF THE SMALL BUSINESS ADMINISTRATION. THESE FAILURES SHOULD SERVE AS AN EXAMPLE OF THE CATASTROPHES THAT CAN TAKE PLACE WHEN GOVERNMENTAL PROGRAMS, EVEN BENEFICIAL PROGRAMS LIKE THE SMALL BUSINESS INVESTMENT COMPANIES, BECOME LARGER THAN THE STAFF ASSIGNED TO ADMINISTER AND OVERSEE THE PROGRAM.

THERE APPEARS TO BE SOME CONFUSION, EVEN BETWEEN THE VARIOUS BRANCHES OF THE SMALL BUSINESS ADMINISTRATION, AS TO WHETHER SBA WAS IN COMPLIANCE WITH FEDERAL LAW IN THE FORMING OF E.W.E TO LIQUIDATE ROYAL BUSINESS FUNDS. THERE ARE EVEN CONFLICTING STATEMENTS AS TO WHETHER SBA ACTED WITHIN THE CONFINES OF THEIR OWN REGULATIONS AND STATUTES.

THESE HEARINGS WILL PROVIDE US WITH AN OPPORTUNITY TO HIGHLIGHT SOME OF THE MISTAKES MADE IN THE PAST BY SBA, SBIC'S, AND SOME OF

THE BUSINESSES THAT USED SBIC CAPITAL. I HOPE THAT THE TESTIMONY AND INFORMATION PROVIDED LAST WEEK BY INSPECTOR GENERAL GILLUM AND THE WITNESSES PRESENT HERE TODAY WILL BE USED TO IDENTIFY AND CORRECT AMBIGUITIES IN THE STATUTORY AND REGULATORY LANGUAGE DEALING WITH SMALL BUSINESS INVESTMENT COMPANIES, AS WELL AS ADDRESSING THE NEED FOR CHANGES IN THE SIZE AND RESPONSIBILITIES OF THE STAFF CHARGED WITH THEIR MANAGEMENT.

SINCE 1958 THE SMALL BUSINESS INVESTMENT COMPANIES HAVE PROVIDED A VEHICLE FOR BANKS AND PRIVATE INVESTORS TO JOIN TOGETHER TO CREATE VENTURE CAPITAL. THE VERY NATURE OF THE SBIC PROGRAM MAKES IT RISKY. THEREFORE, IT IS IMPERATIVE THAT AN ORDINATE AMOUNT OF EMPHASIS BE PLACED ON SUPERVISION OF THE PROGRAM AND THE COMPANIES PARTICIPATING.

IT APPEARS THAT NO MATTER WHO IS TO BLAME OR WHERE WE POINT OUR FINGERS, THIS DEBACLE IS GOING TO COST THE TAXPAYERS A LOT OF MONEY. IF THEY ARE GOING TO GET "ANYTHING" FOR THEIR DOLLAR, WE MUST USE THESE HEARINGS TO IDENTIFY THE MISTAKES THAT WERE MADE IN THE ISSUING OF LICENSES, THE AUDITING PROCESS, AND THE LIQUIDATION PROCEDURES CURRENTLY USED BY THE SMALL BUSINESS ADMINISTRATION.

WE MUST, HOWEVER, SEEK TO DO MUCH MORE THAN IDENTIFY PROBLEMS OF THE PAST--WE MUST USE THE EXPERIENCE GAINED IN THESE RECENT FAILURES AND THE INFORMATION PROVIDED IN THESE HEARINGS TO IDENTIFY SOLUTIONS THAT WILL PREVENT THE SAME COSTLY ERRORS FROM HAPPENING IN THE FUTURE.

The **Chairman**. Thank you. We originally intended to have Mitch Crusto as a witness today but in his place Mr. Hertzberg is appearing. I forgot to take note of that in my opening statement, Mr. Hertzberg; it was not a slight that you were sitting there and not mentioned. In any event we are very pleased to have you here and are anxious to hear your testimony. Please proceed.

STATEMENT OF CHARLES R. HERTZBERG, ACTING ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT, U.S. SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY ROBERT G. LINEBERRY, DEPUTY ASSOCIATE ADMINISTRATOR, INVESTMENT DIVISION; EARL L. CHAMBERS, DIRECTOR, OFFICE OF PORTFOLIO MANAGEMENT; AND ERIC BENDERSON, ASSOCIATE GENERAL COUNSEL FOR LITIGATION, SBA

Mr. **Hertzberg**. Mr. Chairman, distinguished Members of the Committee, it is a pleasure to appear today before you to report on the Small Business Investment Company Program.

My name is Charles Hertzberg. I am the Acting Associate Administrator for Finance and Investment at SBA. I am accompanied today by Mr. Robert Lineberry, the Deputy Associate Administrator for Investment; Mr. Earl Chambers, the Director of the Office of Portfolio Management; and Mr. Eric Benderson, SBA's Associate General Counsel for Litigation.

As you know, the SBIC Program is one the Agency's major programs created by the Small Business Investment Act of 1958. The program has pursued its Congressional mandate to stimulate and supplement the flow of public and private capital into equity and long-term debt financing to both existing and newly-formed small business concerns. The capital, in turn, is used for financing business operations and for business expansion and modernization.

Since the program began in 1958, it has provided almost $9 billion in small business financing. Currently, there are 266 regular SBICs with combined capital assets of $2.6 billion, of which $1.7 billion is private capital. There are 135 specialized SBICs or section 301(d) SBICs with combined financial resources of $504 million, of which $203 million is private capital. Specialized SBICs are statutorily dedicated to assisting small businesses owned or controlled by socially or economically disadvantaged Americans.

We are now experiencing a renewed interest in the SBIC Program as evidenced by an increase in applications for new licenses. The SBIC Program has added 19 new licenses so far this fiscal year, including three specialized SBICs. There are now 35 license applications pending at SBA, 13 of which are for 301(d) licenses.

During calendar year 1989, SBICs provided $542 million to small businesses and specialized SBICs provided $148 million to small businesses owned by socially or economically disadvantaged Americans. Over the last 5 calendar years SBICs have provided $2.6 billion in financing and specialized SBICs have provided $679 million.

SBICs used $50.2 million of SBA guarantee authority during fiscal year 1989 and specialized SBICs used $36 million of direct SBA funds. For fiscal year 1990 through March, SBICs received $26.6 million of SBA guarantees, while specialized SBICs have received SBA funding totaling $7 million.

As of September 15, 1989, the date of the last comprehensive review of the entire SBIC portfolio, 15 SBICs with SBA borrowings aggregating $59.2 million were rated by SBA as unsatisfactory with a loss to SBA likely. Forty-two SBICs with SBA borrowing aggregating $120 million were rated below average with improvement necessary; 119 SBICs with SBA borrowing aggregating $344 million were rated average and 223 SBICs with SBA borrowings of $683 million were rated as being in satisfactory to strong financial condition.

In summary, approximately 15 percent of the SBICs, 57 in number, with aggregate borrowings of $180 million were in unsatisfactory financial condition with the remaining 85 percent in acceptable to strong financial condition.

Over the years some SBICs had defaulted in their obligations to SBA. When this occurs, SBA is required to make payment to the source of the funding, either the U.S. Treasury or the investing public. SBA has paid $517 million as a result of such SBIC defaults over the 32 year history of the program. When a default occurs, SBA makes an effort to collect the borrowed funds from the SBIC through liquidation of their portfolio of investments or by other legal means available such as seeking judgment, voluntary assignment of the assets to the Agency for liquidation, or institution of receivership of the defaulting SBICs. When an SBIC is in this status, the Agency classifies it as in liquidation. Historically, the Agency has been able to collect about 62 percent of the amount due from defaulting SBICs through their liquidation.

We have been taking a careful look at the SBICs currently in liquidation. There are 162 such companies with outstanding borrowings of $480 million due SBA. In response to concerns which were made known to Administrator Engeleiter shortly after she arrived at SBA, she announced on September 1, 1989, the formation of a management team to review SBA's entire SBIC liquidation function. An outside contractor was commissioned to review the SBIC liquidation process and the adequacy of the Agency's resources devoted to that task. A draft of the contractor's study report was issued in January 1990. It set forth a number of recommendations for procedural improvements in the SBIC liquidation process.

In response to these recommendations the following steps were identified to accomplish the improvements: The instituting of new procedures for the valuation of SBIC assets; close out inactive cases in a more expeditious manner; develop specific liquidation plans for each SBIC in liquidation; develop new procedures for more extensive senior management involvement in the decisionmaking on liquidations; develop new instructions for complying with standard operating procedures for receiverships instituted to accomplish liquidations; update the Agency's standard operating procedures governing SBICs in liquidation; develop an upgraded information system on the SBICs that are in liquidation; and increase the staffing for liquidation of defaulted SBICs. The Agency is presently moving forward to implement these steps.

The outside contractor was also asked to review SBIC Program operations in an effort to answer questions as to why SBICs go into liquidation. Accordingly, the operations of the Investment Division were reviewed, including its interaction with the Office of the Inspector General and the SBICs accountants. A reading of the findings and recommendations of this study shows that there is a need to more effectively monitor the investments made by SBICs. This would provide an enhanced early warning that an SBIC is experiencing some financial difficulties so that the SBA may take action to avoid a default by the SBIC. Enhanced monitoring will require more personnel, better information systems and stricter financial reporting requirements. We believe that the combination of steps being taken by the Agency in response to the two program reviews will go a long way toward maintaining the integrity of the SBIC Program.

You have asked that we supply the reasoning of the SBA Investment Division and the General Counsel which supported the establishment of the EWE Properties in light of the language of the Corporation Control Act.

First, let me say that there is a conflict between the views of the Inspector General with respect to the Corporation Control Acts applicability and those reached by the Office of General Counsel and the Chief Counsel for Procurement Law, Thomas Williams, who reviewed this matter as part of a special management team that analyzed the Inspector General's report. Because of this conflict, Administrator Engeleiter submitted the legal issue to the Department of Justice last year for a determination. We are still waiting for an answer to that request.

General Counsel and Mr. Williams concluded that the finding that EWE was improperly established in contravention of the Corporation Control Act was incorrect. In addition they found that there was authority in the Small Business Act, sections 5(b)(4) and 5(b)(7) as well as in orders of the court which had jurisdiction over Royal Business Funds, Inc., to support the formation of a corporation by SBA for the purpose of liquidating the portfolio of Royal. In the case of Royal, EWE was set up in 1984 by SBA employees who were charged with liquidating Royal as part of their official responsibilities. A copy of the General Counsel's comments as well as Thomas Williams' memorandum to Deputy Administrator Kay Bulow have been previously provided to the Committee for review.

With regard to River Capital and Royal Business Funds, you have asked for our views of the reasons for the collapse of these two SBICs. The precise reason for the failures of these two SBICs are difficult to discern. We do know that the 1980s were a difficult time for the venture capital industry as a whole and the SBIC Program itself. Such factors as undercapitalization, weak management, and changing economic conditions, had their effect in these cases. We do know that whether we are talking about these or any other SBICs, annual audits by CPAs, regulatory audits by the Office of the Inspector General, and general oversight by the Investment Division must be relied upon in order to form a true picture of the status of the SBIC. Portions of this effort may have been inadequate in these two cases.

We are now considering ways to improve and expand on-site review of the SBICs in our portfolio to be certain of the ability of management, the estimated values of a valid sampling of portfolio assets, whether investment and operating plans are being followed, and whether proper accounting and valuation methods are being utilized in order to avoid collapses such as Royal and River in the future.

You have also asked that we discuss the recommendations of a 1988 GAO study of the performance of the annual audits of SBICs needed to fulfill SBA regulatory requirements by public accountants. The GAO recommended, among other things, that the accountants follow Generally Accepted Government Auditing Standards in the performance of these audits. SBA disagrees with the recommendation for two reasons.

First, requiring independent auditors to follow Government auditing standards would be duplicative of the work performed by the Agency's Inspector General. Independent auditors perform a financial audit of the SBIC following Generally Accepted Auditing Standards as defined by the American Institute of Certified Public Accountants. On the other hand, the IG performs a compliance audit following the Government standards. We believe that to require both to follow Government standards provides no additional benefit.

Second, requiring independent auditors to follow Government standards would impose a significant burden of increased expense on the SBIC being audited. Estimates of the additional costs run as high as three times the current audit charges. As this work is being performed by the Agency IG, there appears little value in driving up the SBICs' costs for a redundant examination.

I note that the problem encountered with River Capital had nothing to do with the application of Government standards. The trouble in that case concerned the proper valuation of the portfolio and the extent to which both the independent auditors and the IG examiners verified the representations of management. The composition and an accurate evaluation of the licensee's portfolios must be verified by SBA if we are to avoid any more River Capital situations in the future.

I have outlined a number of administrative and regulatory steps which we have already taken to ensure the future integrity of the SBIC Program. It is our view that these steps will enhance the Agency's ability to minimize the Government's exposure in the program while continuing to permit an active Government role in providing venture capital to small businesses.

That concludes our statement and we will be pleased to respond to any questions you have.

[The prepared statement of Mr. Hertzberg follows:]

SBA U.S. Small Business Administration Washington, DC 20416

STATEMENT OF
CHARLES R. HERTZBERG
ACTING ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT
U.S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE
MAY 16, 1990

Mr. Chairman and distinguished Members of the Committee:

I. Introduction

It is a pleasure to appear before you today to report on the Small Business Investment Company Program ("SBIC"). My name is Charles Hertzberg. I am the SBA's Acting Associate Administrator for Finance and Investment. I am accompanied today by Robert Lineberry, Deputy Associate Administrator for Investment, Earl Chambers, Director, Office of Portfolio Management and Eric Benderson, Associate General Counsel for Litigation.

II. Mission of the Program

As you may know, the SBIC program is one of SBA's major programs. Created by the Small Business Investment Act of 1958, the program has vigorously pursued its Congressional mandate to stimulate and supplement the flow of public and private capital into equity and long-term debt financings to both existing and newly-formed small business concerns. This capital in turn is used for financing of business operations and the promotion of growth, expansion and modernization.

III. Status of the Program

Since the program began in 1958, it has provided almost $9 billion in small business financing. Currently, there are 266 "regular" SBICs with combined capital assets of $2.6 billion, of which $1.7 billion is private capital. There are 135 "specialized" or Section 301(d) SBICs (commonly referred to as "MESBICS") with combined financial resources of $504 million, of which $203 million is private capital. Specialized SBICs are statutorily dedicated to assisting small businesses owned by socially or economically disadvantaged Americans.

We are now experiencing a renewed interest in the SBIC program, as evidenced by a recent increase in applications for new licenses. The SBIC program has added 19 new licensees so far in Fiscal Year 1990, including three Specialized SBICs. There are now 35 license applications pending at SBA, of which 13 are for 301(d) licenses.

During calendar year 1989, SBICs provided $542 million to small businesses in 1,876 financings, and Specialized SBICs provided $148 million to small businesses owned by socially or economically disadvantaged Americans in 1,446 financings. Over the last five calendar years, SBICs have provided $2.6 billion to small businesses and Specialized SBICs have provided $679 million.

SBICs used $50.2 million of SBA guarantees during Fiscal Year 1989, and Specialized SBICs used $36.0 million of direct SBA funds. For FY 1990 through March, SBICs received $26.6 million of SBA guarantees, while Specialized SBICs have received SBA funding totaling $7.0 million.

IV. Assessment of the Overall Health of the SBIC Industry

As of September 15, 1989, the date of the last comprehensive review of the entire SBIC portfolio, 15 SBICs, with SBA leverage aggregating $59,220,000, were rated by SBA as unsatisfactory with loss to SBA likely. Forty-two (42) SBICs, with SBA leverage aggregating $120,812,500, were rated at below average with improvement necessary. One hundred and nineteen (119) SBICs, with SBA leverage aggregating $344,437,228, were rated average. Two hundred and twenty-three (223) SBICs, with SBA leverage aggregating $683,764,995, were rated as being in satisfactory to strong financial condition.

In summary, approximately 15 percent of the SBICs (57 in number) with aggregate leverage of $180,032,500 (14.9 percent of total leverage outstanding) were in unsatisfactory financial condition while 85 percent were in acceptable to strong financial condition.

It should be noted that these figures represent a snapshot of the SBIC portfolio at a certain point in time. Subsequent to September 1989, several of the SBICs found to be in unsatisfactory condition at that time have been transferred into liquidation status. It should also be noted that the financial condition of an SBIC at any given point is a subjective matter which may change as a result of economic and other factors.

V. SBICs in Liquidation

Throughout the history of the SBIC program, the SBA has provided $2.98 billion in funding to venture capital firms to invest in small business. Over the years, some SBICs, due to a series of factors, have defaulted on their obligations to SBA. When this occurs, SBA is required to make payment to the source of the funding, either the U.S. Treasury or the investing public. To date, SBA has paid $517 million as a result of such SBIC defaults over the 32-year history of the program.

When a default occurs, SBA makes efforts to collect the "borrowed" funds from SBICs through liquidation of their portfolios of investments or by other legal means available to us, such as seeking judgments, voluntary assignment of assets to the Agency for liquidation and institution of SBA receiverships of the defaulting SBICs. When an SBIC is in this status, the Agency classifies it as in liquidation. Historically, the Agency has collected about 62 percent of the indebtedness owed to it from the liquidation of SBIC's through the various means available to it.

As a result of initiatives specifically authorized by Administrator Engeleiter, we have been taking a careful look at the SBICs currently in liquidation status. There are 170 such companies which have borrowed a total $486.2 million from SBA. We believe a combination of factors is responsible for an upturn in the number of SBICs which are in liquidation. These factors include a) the "bursting" of the high technology investing bubble of the late 1970's and early 1980's; b) the 1986 repeal of the income tax exclusion on capital gains; and

c) the 1987 stock market collapse which depressed prices and seriously limited the opportunity to take young companies "public" at appreciated stock prices.

All of this depressed profits for SBICs which had borrowed from SBA, often at very high interest rates during the late 1970's and early 1980's. We believe the combination of these factors has led directly to the large number of SBIC's which are now unable to pay their indebtedness and are therefore in a liquidation status.

In response to concerns which were made known to Administrator Engeleiter shortly after she arrived at SBA, she announced on September 1, 1989, the formation of a management team to review SBA's entire SBIC liquidation function. An outside contractor was commissioned to review the SBIC liquidation process and the adequacy of the Agency's resources devoted to the task. A draft of the contractor's study Report was issued in January 1990. It provided a number of recommendations concerning SBIC liquidation procedural improvements.

In response to these recommendations, a working group was established within SBA, and charged with the responsibility of responding to the Report's recommendations. The group has identified several areas for improvement and made the following recommendations to accomplish those improvements:

1. Institute new procedures for the valuation of SBIC assets;
2. Close out inactive cases in a more expeditious manner;
3. Develop specific liquidation plans for each liquidation;
4. Develop new procedures for more extensive senior management involvement in decisionmaking on liquidations;
5. Develop new instructions for complying with Standard Operating Procedures for receiverships instituted to accomplish liquidations;
6. Update the Agency's Standard Operating Procedures governing SBICs in liquidation;
7. Develop an upgraded information system on the SBIC's in liquidation; and
8. Increase staffing for liquidation of defaulted SBICs.

The Agency is presently moving forward to implement these recommendations.

VI. Review of SBIC Program Operations

The outside contractor was also asked to review SBIC program operations in an effort to answer questions as to why SBICs go into liquidation. Accordingly, the operations of the Investment Division which administers the SBIC program were reviewed, specifically including its interaction with the SBA's Office of Inspector General and the SBICs' accountants. We have evaluated the findings and recommendations of this study Our reading shows that there is a need to more effectively monitor the investments made by SBICs. This allows SBA to have an enhanced early warning that an SBIC is experiencing financial difficulty so that SBA may avoid a default on its obligations. Enhanced monitoring will require more personnel, better information systems, and stricter financial reporting requirements. We believe that the combination of steps being taken by the Agency in response to the two program reviews will go a long way toward maintaining the integrity of the SBIC Program.

VII. Legality of EWE Properties, Ltd.

You have asked me to supply the reasoning of the SBA's Investment Division and the General Counsel which supported the establishment of EWE Properties, Ltd. (EWE), in light of the language of the Corporation Control Act.

First, let me say that there is a conflict between the views of the Inspector General, with respect to the Corporation Control Act's applicability, and those reached by the Office of General Counsel, and the Chief Counsel for Procurement Law, Thomas Williams, who reviewed this matter as part of a special management team that analyzed the Inspector General's report. Because of this conflict, Administrator Engeleiter submitted the legal issue to the Department of Justice last year for a determination. We are still waiting for an answer to that request.

To specifically respond to your question, however, the General Counsel and Mr. Williams concluded that the finding that EWE was improperly established in contravention of the Corporation Control Act was incorrect. In addition, they found that there was authority in the Small Business Act (specifically sections 5(b)(4) and 5(b)(7) which are incorporated into the Small Business Investment Act), as well as in orders of the court which had jurisdiction over Royal Business Funds, Inc. (Royal), to support the formation of a corporation by SBA for the purpose of liquidating the portfolio of Royal. In the case of Royal, an SBIC in liquidation, EWE was set up in 1984 by SBA employees who were charged with liquidating Royal as part of their delegated responsibilities. A copy of the General Counsel's comments, as well as Thomas Williams' memorandum to Deputy Administrator Kay Bulow, have previously been provided to the Committee for review.

VIII. The Collapse of River Capital Small Business Investment Company and Royal Business Funds Corp.

You have asked for our views of the reasons for the collapse of these two SBICs. The precise reasons for the failure of these two SBICs are difficult to discern. We do know that the 1980's were a difficult time for the Venture Capital Industry as a whole, and the SBIC program itself. Such factors as undercapitalization, weak management and changing economic conditions had their effect in these cases. We do know that whether we are talking about these, or any other SBICs annual audits by CPAs, regulatory audits by the Office of the Inspector General, and general oversight by the Office of Investment must be relied upon in order to form a true picture of the status of an SBIC. Portions of this effort may have been inadequate in these two cases. We are now considering ways to improve and expand onsite review of the SBICs in our portfolio to be certain 1) of the managers demonstrated ability to manage, 2) the estimated values of a valid sampling of portfolio assets, 3) whether investment and operating plans are being followed and 4) whether proper accounting and valuation methods are being utilized, in order to avoid collapses such as Royal and River in future.

IX. Response to Recommendations of GAO Concerning SBA's Audit Policies

You have asked that we discuss the recommendations of a 1988 GAO study of the performance of Annual Audits of SBICs needed to fulfill SBA regulatory requirements by public accountants. The GAO recommended, among other things, that the accountants follow Generally Accepted Government Auditing Standards (GAGAS) in the performance of those audits. SBA disagrees with the recommendation for two reasons.

First, requiring independent auditors to follow GAGAS would be duplicative of the work performed by the Agency's Inspector General. Independent auditors perform a financial audit of the SBIC following Generally Accepted Auditing Standards (GAAS) as defined by the American Institute of Certified Public Accountants (AICPA). On the other hand, the IG performs a compliance audit following GAGAS. We believe that to require both to follow GAGAS provides no additional benefit.

Secondly, requiring independent auditors to follow GAGAS would impose a significant burden of increased expense on the SBIC being audited. Estimates of the additional costs run as high as three times the current audit charges. As this work is being performed by the Agency IG, there appears little value in driving up the SBICs' costs for a redundant examination.

I note that the problems encountered with River Capital have little to do with the application of GAAS or GAGAS. The trouble in that case concerned the proper valuation of the portfolio and the extent to which both the independent auditors and the IG examiners verified the representations of management. Personnel will be provided the Office of Investment to perform on site inspections to address just this point, among other things. The composition and a reasonably accurate valuation of the licensees' portfolios must be verified by SBA if we are to avoid any more River Capital situations in the future.

X. Steps To Be Taken

I have outlined above a number of administrative and regulatory steps which we have already taken to ensure the future integrity of the SBIC program. It is our view that these steps will enhance the Agency's ability to minimize the Government's exposure from the program while continuing to permit an active Government role in providing venture capital to small businesses.

I will be pleased to respond to any questions you may have.

SENATE SBIC HEARING

May 16, 1990

Charles R. Hertzberg
Acting Associate Administrator
for Finance and Investment

Question 1: Your testimony with respect to the amount owed by the some-170 SBIC's now in liquidation substantially differs from that of Inspector General Gillum, who stated that these companies owe SBA about $563 million. You stated that they owe only $486.2 million. How do you account for this discrepancy?

Answer: The original number used in our statement, and the $563 million, are really two different numbers. The figure of $486 million represents the principal amount due on the 170 SBIC cases at the time each was transferred into liquidation. The $563 million figure (attributed to the Inspector General) was contained in the Irving Burton Study, and is reported to be the principal balance of $446 million, plus $117 million in interest due on SBIC's in liquidation as of 9/30/89.

Question 2: You referred to a study of the industry performed in September 1989. Who conducted this study, and has a copy been supplied to the Committee? If not, please supply one.

Answer: The study initiated in September, 1989, was phase 1 of a two phase study. It was performed by Irving Burton & Associates, and covered the handling of SBICs already in liquidation. The results were received in January, 1990. Phase 2 was initiated in January, and the results were received in April, 1990. Both studies have been supplied to the Committee.

Question 3: You stated, "Subsequent to September 1989, several of the SBICs found to be in unsatisfactory condition at that time have been transferred into liquidation status."

- How many is "several"?
- How many were found to be in unsatisfactory condition that were not transferred to liquidation?
- How did you define unsatisfactory condition?

Answer: As stated in my testimony, 15 SBICs were rated as unsatisfactory with loss to SBA likely. Of the 15, 9 have been transferred to the Office of Portfolio Management for liquidation and 6 have not been transferred. Unsatisfactory condition means "Unsatisfactory financial condition and performance. Loss to SBA likely." As a practical matter, it usually applies to a company which has lost fifty (50%) percent or more of its private capital investment.

Question 4: With respect to the 42 SBICs with leverage (borrowing) totaling $120.8 million, which you found to be below average, what steps have been taken?

Answer: These companies have been identified as below average performers with improvement necessary. As a practical matter, these companies, absent an improvement in their financial condition, will not receive any additional leverage from SBA. Otherwise, they are monitored in much the same way as other SBICs with better ratings. However, we are now in the process of developing written procedures for dealing with these companies which will include portfolio assessments and get-well plans.

Question 5: What has been the overall attrition rate in the SBIC program over the last five or so years?

- How many SBICs have voluntarily turned in their license as opposed to forced liquidations or receiverships. That is, how many companies elected to stay in the venture capital industry but without SBA's help?

Answer: The following table provides the data requested. This compares with an attrition rate of 79% of SBICs and 54% of 301(d) SBICs since inception of those programs in 1958 and 1972, respectively. While we have no information on the subsequent activity of surrendered licensees, we believe that very few continued to be venture capital sources.

	SBICs	301(d)SBICs
# Licensees as of September 1984	381	146
Licensed	95	41
Surrendered	115	20
Revoked	5	1
Transferred for Liquidation	77	33
Merged	6	1
# Licensees as of September 1989	273	132
% Attrition	28%	10%

Question 6: You noted three factors which have contributed to the recent increase in SBIC liquidations, one of which was repeal of the capital gains exclusion in 1986. How did repeal of capital gains contribute to SBIC failures?

Answer: Historically, over half of the small business financing provided by SBICs has been wholly or partly in the form of equity. In the last ten years, the proportion of equity and equity-type financing has increased to about two-thirds of the program's activity. Accordingly, capital gain on the sale of these equity positions is the major source of return on investment. For example, in FY 1989, SBICs on a composite basis reported before-tax gross portfolio interest and dividend income of $148.7 million and realized gain on sale of securities of $211.8 million. The loss of the capital gains exclusion, followed quickly by a sharp decline in the initial public offerings market, reduced opportunities for SBICs to exit profitably from investments made with dollars borrowed at the high interest rates of the early 1980's. As stated in our testimony, it was one of several macro factors which depressed profits and may have contributed to SBIC failures.

Question 7: You stated that historically SBA has collected about 62% of the indebtedness owed by SBICs in liquidation. What is the basis of this 62% estimate?

- How much of the indebtedness owed by SBICs in liquidation has actually been charged off?

- **For those loans which have not been charged off--but where default has clearly already occurred--how does this affect the calculations about loss rates for this program?**

- **What is the loss rate to date, and what is the projected loss rate over time?**

Answer: Although my statement said historically our recovery rate had been 62%, that rate had actually been 71% through 9/30/89. We calculated our expected recovery on those SBICs currently in liquidation at approximately $266 million. This calculation resulted in a projected recovery rate of approximately 62% (including the effect of the anticipated 100% loss on River Capital.) The actual loss rate at 4/30/90 stood at 2.1%, with a projected loss rate of 9.4%, using the recovery figure of $266 million. This projected loss rate would increase to 12.8% if we add all active SBICs to this calculation.

Actual charge-offs in the history of the program total $65 million.

Question 8: You stated that in the 32-year history of the SBIC program, SBA has paid out about $517 million as a result of SBIC defaults, which averages to about $16.5 million annually. How would you describe the curve over a period of time of these losses; that is, have the losses been fairly evenly distributed over time or has the industry been cyclical?

Answer: The payout on SBA guaranteed debentures for SBICs has not been evenly distributed over time. Because of the rising level of SBA funding for individual SBICs, and the increasing number of companies being transferred into liquidation, roughly half of all payouts occurred since 1985. In the previous five year period, just over one quarter of the payouts took place. By contrast, less than one quarter of the payouts occurred in the previous twenty years.

Question 9: At least a half dozen times in your testimony, Mr. Hertzberg, you refer to the need for more personnel to monitor and identify problems in this program. In your conclusion, you state "personnel will be provided the Office of Investment to perform on-site inspections to address just this point, among other things." (Emphasis added)

- How many personnel will be provided and where will they come from?
- Has OMB approved any new allocation of FTE's to the agency?
- Has any such request been made of OMB?
- When do you intend to make such a request?

Answer: We anticipate that it will require 6-10 positions to accomplish on-site inspections of SBICs on a regular basis. Temporarily, staffing will have to come from existing personnel plus contract employees. To date no new allocation of FTEs has been approved by OMB, nor has a formal request been made. We anticipate that a formal request will be submitted June 30.

Question 10: If you decline to follow the recommendations of the GAO regarding changes in your audit procedures, but you agree that "there is a need to more effectively monitor the investments made by SBICs," what exactly do you propose to do?

Answer: Our statement at the time of the hearing dwelled on the point that, since we look to the Inspector General for compliance review, it would be duplicative to have an SBICs private auditor follow government standards (GAGAS). It seems necessary that we enlarge on that answer to make a further point clear. Under no circumstances could we accept the findings of the SBIC's employed auditor as our means of determining regulatory compliance. This would constitute a clear conflict of interest.

If, however, a private sector audit firm (other than that firm employed by the SBIC) were to perform regulatory audits under contract to the agency, this would necessitate the following of government standards as a provision of the contract. This would provide an acceptable alternative. In the meantime, we shall have to use existing resources for monitoring.

QUESTION: Mr. Lineberry, as you review the record of River Capital with the benefit of hindsight, do you now see "red flags" in either previous CPA audits or Inspector General's reports which should have alerted the Investment Division to River Capital's financial peril?

ANSWER: In view of anticipated litigation concerning this case, a response to this question appears inappropriate at this time.

QUESTION: What has been the experience of the Investment Division with respect to numbers and adequacy of staffing since you joined SBA in 1981?

ANSWER: There has been a reduction in the staff from 33 in 1981 to 27 as of May 1990.

As of May 1990, there were 401 SBICs under the jurisdiction of the Investment Division with outstanding SBA-leverage of $1.2 billion and private capital of $1.9 billion for total capital resources of $3.1 billion, the greatest in the SBIC Program's 32 year history. In addition, the SBIC Industry has become increasingly more complex in its structure and activities.

QUESTION: For both Mr. Lineberry and Mr. Chambers, how many staff were employed in your respective offices in January of 1981, and how many are employed there today?

ANSWER: MR LINEBERRY: In early 1981, the Investment Division staff consisted of 33 employees. Currently the staff consists of 27 employees.

MR. CHAMBERS: In January 1981, there was 1 professional and 1 clerical assigned to the SBIC Liquidation function. Two (2) additional professionals were added in 1985, 2 more were added in 1987, and 1 more was added as of May 1990. Accordingly, there are currently 6 professionals and 1 clerical assigned to the SBIC Liquidation function.

SENATE SBIC HEARING

Eric S. Benderson
Associate General Counsel
for Litigation

Question 1: Mr. Benderson, Mr. Hertzberg stated in his testimony that orders of the court which had jurisdiction over Royal Business Funds, Inc., supported formation of EWE Properties, Ltd. That isn't actually the case, is it? Did the District Court ever specifically approve the establishment of EWE?

- You stated to the staff yesterday that EWE was established pursuant to the settlement agreement and consent judgment which dismissed the receivership action. That consent judgment was a precedent prepared by the attorneys for Royal Business Funds, was it not? That is, did Judge Conner ever rule on the appropriateness of EWE?

Answer To Question 1: On May 8, 1984, the United States District Court for the Southern District of New York entered a Consent Judgment and Order which resolved the protracted litigation between the SBA receivership of Royal Business Funds Corporation (Royal) and Royal's controlling shareholder, Seon Pierre Bonan.

The Consent Judgment and Order, as its name implies, was the result of negotiations between counsel for the SBA Receiver and for the shareholders of Royal. Judge Conner, who oversaw the receivership, as well as the settlement negotiations, approved the terms of the Consent Judgment and Order, including the provision (paragraph 10), which specifically provided for the transfer of Royal's assets to SBA or an SBA owned corporation (EWE Properties, Ltd. (EWE)). Moreover, the receivership remained in existence until its termination on April 6, 1987. One of the reasons it remained open was for the purpose of allowing the Court to resolve any disputes that might arise with respect to SBA or EWE, including any challenge to the legality or conduct of EWE. While no such challenge occurred, my motion for the termination of the Royal receivership specifically stated "the Receiver and its agents transferred the assets of Royal Business to SBA and a corporation it owned and controlled, EWE Properties, Ltd. . . ." In terminating the receivership in direct response to this motion, Judge Conner approved all the actions taken by the Receiver, which included the Receiver's formation of EWE.

Question 2: Mr. Benderson, what prompted your memorandum to the Acting Comptroller, Mr. Rosenbaum, dated March 25, 1987? Was Mr. Rosenbaum aware of EWE prior to this memo? Did he object to EWE?

- Was Mr. Rosenbaum aware that EWE, as reported by the Inspector General, did not have an accounting system during its first two years of operation?

- Was the former Comptroller, the late Harry Carver, aware of EWE?

- Was the former Associate Administrator, Mr. Holloway, aware of EWE?

- Were no questions raised about the appropriateness of this enterprise by anyone in either the Finance and Investment office or the General Counsel's office?

Answer To Question 2: Mr. Harry Carver was the Agency's Comptroller at the time of EWE's formation in 1984. I, together with the Chief, Operations Assistance Branch, Office of Portfolio Management, discussed EWE's formation with Mr. Carver, informing him of its purpose and its role in the Royal liquidation. He was informed of EWE's formation and operation so that we could get his views from the standpoint of the operations of the Comptroller's Office. He did not express any objections. On a number of other occasions EWE was discussed with him subsequent to its formation. I am informed that Mr. Carl Hauser, who was in the Comptroller's Office at the time, was also aware of EWE's operation. The Comptroller's Office was also aware of EWE's formation and purpose through SBA Forms 327, which documented financial transactions occurring on behalf of EWE.

Up until his death, Mr. Carver had been my primary contact with the Comptroller's Office. Shortly after Mr. Carver's death, Mr. Rosenbaum became Acting Comptroller. I do not know the circumstances under which he became aware of EWE's existence, but I do recall that we discussed its nature and operations at a meeting attended by Mr. Chambers, the Chief of the Operations Assistance Branch, and me, shortly after Mr. Rosenbaum became Acting Comptroller. We provided Mr. Rosenbaum with background information with regard to EWE, and discussed the legal issues addressed in my memorandum of March 25, 1987. He did not object to EWE's operations and seemed satisfied with the memorandum.

Although I was not involved with the operation of EWE's accounting system, I take issue with the view that EWE was without an accounting system for two years. It is my understanding that EWE did, in fact, have an accounting system as soon as it became active in the fall of 1984. Initially, it simply continued the accounting system that the Royal receivership had in place.

Subsequently, the EWE accounting operations were moved from New York to Washington and its accounting system was improved. The two year period in question was the time period in which EWE was taking control of and organizing the many facets of Royal's operations. Nevertheless, EWE was able to provide the Inspector General's Office with a listing of every check by number, payee, date, and amount during this two year period in order to assist the Inspector General's investigation.

It is my understanding that Mr. Holloway was aware of the Royal liquidation and the problems we faced with Mr. Bonan. As stated by Mr. Hertzberg in his memorandum of June 23, 1989, to Mr. Holloway regarding the draft of the Inspector General's Audit Report: "In addition, the [Deputy Associate Administrator for Finance and Investment] and the [Associate Administrator for Finance and Investment] were aware of the case, the general efforts to sell the assets, and the need to protect the water rights and operate the facility. While not involved in every detail, a reasonable level of supervision was exercised."

Mr. Hertzberg, who was Mr. Chambers' immediate superior, has informed me that he subsequently became aware of EWE's creation and operation. No questions were raised about the appropriateness of EWE by anyone in either the Finance and Investment Office or the General Counsel's Office.

Question 3: Who within the Agency was aware of approval of the establishment of EWE Properties, on the front-end?

- Who within the Agency later became aware of EWE during its operations?

- Mr. Chambers stated to the staff yesterday that he had discussed EWE specifically with former Administrator, James Sanders - which, incidently, contradicts the report of the Inspector General. Was a Form 606 circulated within the agency concerning EWE?

Answer To Question 3: Mr. Chambers had complete delegated authority to take any and all actions with respect to the liquidation of SBICs. A Form 606 concerning the formation of EWE was not circulated within the Agency, because such a form was not necessary in view of the broad delegation of authority to Mr. Chambers from the Administrator. This was consistent with past Agency practice with regard to the liquidation of SBICs.

At the time of EWE's formation it was discussed among members of Mr. Chambers staff, myself, the Receiver's corporate attorney in New York, Mr. Carl Kaminsky, as well as the agent for the Receiver, Mr. Alan Slaman. It was discussed shortly thereafter with the Agency's Comptroller, Harry Carver as set forth previously. Subsequently, as also discussed above, other officials of the Comptroller's Office became aware of its operations, including Acting Comptroller Rosenbaum, Mr. John Lagos and Mr. Carl Hauser.

Mr. Grant Moy, Special Assistant to then General Counsel Robert B. Webber as well as former Associate General Counsel for Finance, was aware of EWE and other aspects of the Royal liquidation at an early stage. Other Agency officials who were aware of the Royal liquidation and in a general sense various aspects of EWE's activities after its formation, included former General Counsel Robert B. Webber and the SBA Regional Counsel and Assistant Regional Counsel in New York, Jack Matthews and Joseph Hallock, respectively. The Regional Counsel in Denver, George DeRoos, and the Assistant Regional Administrator for Finance, Russell Berry, were also aware of the EWE operation. Robert Lineberry, Deputy Associate Administrator, Investment Division was aware of EWE after its formation. It is also my understanding, as you state, that Mr. Chambers discussed the difficulty in obtaining liability insurance for the officers and directors of EWE with Administrator Sanders.

It should be kept in mind that EWE was not viewed as a legally controversial issue during most of its operations, but rather as Mr. Hertzberg has explained in his response to Senator Lieberman's questions on May 16, 1990, was looked at as simply a vehicle to facilitate the management, operation, and liquidation of Royal's former subsidiary corporations.

Question 4: Mr. Benderson, you stated in your memo to Mr. Rosenbaum that "since the formation of EWE in July, 1984, all excess funds in the Royal Business estate have been paid over to SBA and applied against the Royal Business indebtedness."

- Who defined "excess funds"?

Answer To Question 4: This is my reference to funds that were not needed for operations and could be used to retire the outstanding indebtedness owed SBA by Royal.

Question 5: Who was the General Counsel for the Agency at the time EWE was established? Did he approve the establishment of EWE as an SBA-owned corporation?

Answer To Question 5: Robert B. Webber. No.

Question 6: What are the Agency's plans regarding possible litigation against Arthur Andersen and Company over the failure of River Capital?

Answer To Question 6: We are closely examining the possibility of filing suit against Arthur Anderson and Company in part with regard to its role with respect to the valuation of River's assets. We are working with attorneys at the Department of Justice, and expect to take action in this regard within the next two or three months.

The **Chairman.** Thank you very much, Mr. Hertzberg. Mr. Hertzberg, first of all you say, historically, you have collected 62 percent of SBA's debt in these liquidations. Now that is historically; how well did you do in the case of Royal?

Mr. **Hertzberg.** I will ask Earl Chambers to give us the figures if he could.

Mr. **Chambers.** Sir, the liquidation is not totally complete yet. We anticipate it will be approximately $8 million net recovery, including repaying the Treasury the $5.5 million we obtained on receiver certificates.

The **Chairman.** You plan to recover over $8 million in addition to the additional amount you put into Royal?

Mr. **Chambers.** Yes, sir.

The **Chairman.** And what was the total debt?

Mr. **Chambers.** At the time we took over it was $18 million in principal and about $5.5 million in interest.

The **Chairman.** Counting principal and interest, you will get about one-third, 33 percent?

Mr. **Chambers.** Yes, sir.

The **Chairman.** How about River Capital?

Mr. **Chambers.** I will have to defer to Eric on that. It's in the Courts.

Mr. **Benderson.** From the company itself we anticipate a total loss. The bankruptcy examiner concluded in a report that he submitted to the bankruptcy court that it would be—the assets were worth $1 to $4 million. There is roughly $3.5 million ahead of us held by banks; the rest may go to expenses. There are other sources of recovery that might result from possible litigation. I would prefer not going into it publicly. But at this point from the portfolio itself we do not expect any recovery.

The **Chairman.** And how much did River Capital owe SBA?

Mr. **Benderson.** Twenty-eight and a half million plus interest.

The **Chairman.** How much did you say—what did you say you expect to collect?

Mr. **Benderson.** Zero from the portfolio.

The **Chairman.** I have two questions. No. 1, we have as you know Arthur Andersens' audit of December 1987 showing this corporation to be in fairly excellent condition and with a net worth of $28 to $35 million. Eight months later, they are in liquidation. We are not going to get anything. So I assume that, No. 1, you would agree with me that these audits we are doing are woefully inadequate to advise Mr. Hertzberg or Mr. Crusto or whoever about the real condition of the company; would you agree with that?

Mr. **Benderson.** I would totally agree with that. If I might add one comment, and this is outside of my area of expertise, but I would comment because I have had a lot of experience in this program, the biggest problem you have in monitoring these companies is knowing what the value of the assets are. All we have is an annual audited financial report that is prepared by the CPA and the firm and an IG regulatory audit which is not adequate in determining what the value of those assets are. The biggest problem, and I do the backend of the financing with Mr. Chambers here, the biggest problem you have is when you get into a company, whether it is Royal, whether it is the XYZ SBIC, the biggest problem you have is you have no idea what the values of those assets are. I will tell this Committee they are usually not in accord with what has been presented to the Agency. That is a significant weakness in the program. We are currently exploring ways to correct that. In this management study that was talked about, that has been done, it is much closer monitoring of the portfolios.

The **Chairman**. Let me follow up that question along the line you are talking about by asking this question: in the case of River Capital, Arthur Andersen sat in on a board meeting and they listened to the board members of River Capital discuss the value of the roughly 40 portfolios that they held, the 40 companies that they had invested in. Arthur Andersen said, using their best judgment and based on the discussion at this all-day board meeting, they arrived at these figures of what these corporations were worth. It is obvious on hindsight that that was an extremely poor method. But, even at the time, one of these stocks of a company that River Capital had loaned money to, one of the stocks in the company was selling on the open market for 2 cents per share which made the SBIC's value, their worth of that stock, about $73,000. Yet, Arthur Andersen put it at over $1 million.

Mr. **Benderson**. I have heard that explanation and I think that they would counter your argument; I agree with you.

The **Chairman**. I would like to hear what the counter is.

Mr. **Benderson**. The counter is that you are looking only to one class of stock. I cannot remember if it is common or preferred. I think they would say you were looking at the common stock. But, if you are looking at the preferred stock, it had a greater value. I do not necessarily agree with that, but that is their explanation.

There is no question that in the River Capital case, which I would add is the biggest loss in the SBA history, and I would not characterize the whole program that way, but, that it was a very, very serious overestimation of the value of those assets. I think that will be the subject of future litigation involving the officers, directors and perhaps the accountants, but I would not want to go much farther than that. I do not feel it is really responsible for me to make wild allegations without people here to defend themselves.

The **Chairman**. I am not asking you to do that. But, one of the purposes of this hearing is to try to determine what we need to do to make sure we do not have a repetition of River Capital, No. 1. And, No. 2, to determine the health of these 223 SBICs which Mr. Hertzberg says are in satisfactory condition and the 119 that he says are in average condition. Mr. Hertzberg has testified that we have 15 where SBA's almost $60 million exposure is almost certainly going to result in a loss.

Mr. **Hertzberg**. Mr. Chairman, 57; 15 percent.

The **Chairman**. You listed 15 SBICs that owe SBA $59,220,000 and you say that a loss is likely. I would say that you could book it. Then, you have an additional 42 with an exposure at SBA of $120,812,500 which you say is below average and it would be fair to say you are going to sustain a substantial loss in that; would it not, in those?

Mr. **Lineberry**. Senator, as far as the extent of the loss we might sustain in those cases, we are not sure exactly how many of those will actually result in loss or default or will have to be liquidated.

Those are marginal companies that we are watching. I think the 15 in the bottom category with loss likely are ones that, obviously, we have identified as having a very high probability of loss.

The CHAIRMAN. Mr. Lineberry, let me ask you this question. Based on what we know about these draft audits and especially the one Arthur Andersen did on River Capital—they sent in a draft audit saying that River Capital is in good, fine, healthy condition—we know 8 months later that they were hopelessly bankrupt at the time. I do not think there is any question about that, and we wind up with zero for our $28 million investment. My question is: How do we know and how did you determine that these 57 are in bad or fairly sorry condition?

Mr. LINEBERRY. Senator, we did a rating based on both financial condition of the company and their regulatory compliance status at the time the rating was done which was last September. The rating assigned to the company reflects a combination of those factors as evaluated by the staff.

The CHAIRMAN. Is that largely based on these in-house audits or CPA independent audits?

Mr. LINEBERRY. It is obviously based on information that we have received. All I could add to that is that we have in the last few years changed the accounting guidelines. We have tightened up the reporting procedures, our credit evaluation procedures; we have now built, since 1987, a data base of financial information on each SBIC. We are implementing a computerized spreadsheet analysis arrangement that is in place now where we will be using standard comparative ratios and trend analysis through linkage of each analyst's personal computer to the data base. Those are some things that we already have in place.

The management study that was ordered by Administrator Engeleiter, which was referred to earlier, identified some further things that we could do to closer monitor the companies. One of the key recommendations in that study was that we do on-site reviews of the SBICs for the purpose of looking at the condition of the investments in their portfolios. That is something that would require additional resources of some type to perform. It is an area that we are very interested in doing; that we are looking into.

We would like to also advise you that we could go out and take a close look at approximately 60 SBICs out of the 400 which will represent over 50 percent of the Government's financial exposure. So that is another area that we are focused on right now.

The CHAIRMAN. Mr. Lineberry, has OMB signed off on all these new resources you are talking about?

Mr. LINEBERRY. They have not.

The CHAIRMAN. The other day Inspector General Gillum testified that virtually nothing had been done to change the modus operandi at SBIC in determining the financial health and viability of all the SBICs. Now you said in your testimony and you are saying now that you have taken steps. I am not at all clear what those steps are that are different from what we are doing right now.

For example, you say we are considering ways to improve and expand on-site review, this is your testimony, Mr. Hertzberg. You say we are now considering ways to improve and expand on-site review of the SBICs in our portfolio. I quote: 1. to be certain of the manager's demonstrated ability to manage; 2. the estimated values of a valid sampling of portfolio assets; 3. whether investment and operating plans are being followed; and 4. whether proper accounting and valuation methods are being utilized in order to avoid collapses such as Royal and River in the future.

Now, you say you are considering ways to do that. Apparently nothing has really been implemented.

Mr. LINEBERRY. Senator, these are recommendations which fall out of a management study which was recently completed. An implementation plan has been put together; we have begun to implement some of the initial steps in that plan. Obviously, the steps that would require resources are the ones that are still under consideration because, as you indicate, those resources are going to have to be approved by somebody and available to be employed in this task.

But let me just go back a little bit. We are focused here on two cases, Royal Business Funds which went into liquidation in 1982 and River Capital which went in in 1988. In both cases those companies had been licensed sometime prior to a number of changes that have been made in the program over the last several years. For example, in 1983 we completely revised the regulations. At that time we tightened up the licensing standards, we raised the minimum capital requirement, and we added management experience criteria. Those are elements that were not present in the licensing process previously.

We also, along the way, have tightened up our procedures for reviewing funding applications.

Even prior to the latest step which is the computerized spreadsheet analysis, we had put in some additional liquidity computations and other calculations to help us screen out problem SBICs in the funding process.

In 1986, it began to be implemented in 1987, we completely revised the accounting guidelines and the financial reporting forms for the program. Then, as I indicated about the same time, we began building a data base. Within the resources that have been available for the job over the last several years, we have taken, I feel, a significant number of steps. We are never happy to see any SBIC failure that results in liquidation and loss to the Government. Obviously, we have gone through a curve here where a number of companies had to be transferred into liquidation. The peak for that——

The CHAIRMAN. You said several, how many is several? In Mr. Hertzberg's testimony, he said several have been transferred into liquidation; how many is that?

Mr. LINEBERRY. Over the years the number of companies transferred in a liquidation, I think is a number exceeding——

The CHAIRMAN. I am talking about since September 1989.

Mr. LINEBERRY. Since September 1989 we have transferred nine companies to liquidation.

The CHAIRMAN. Mr. Lineberry, I hate to interrupt you, but I want to get into this.

Let me ask you, would you agree with me that you cannot determine the health of an SBIC until you know the health of the companies that that SBIC has invested in. That is a fair statement is it not?

Mr. **Lineberry**. That is a fair statement.

The **Chairman**. So you would agree with me that unless you go behind the bookkeeping of an SBIC as to the valuation of the corporations, in River Capital's case 40 separate corporations, in order to know the health of an SBIC you have to know the health of those companies they have invested in.

Now, you say here that the report that came out in January of this year on recommendations as to how to deal with this in a better way, you say the recommendation was to institute new procedures for the valuation of SBIC assets. What have you done, if anything, to implement that?

Mr. **Lineberry**. The report that came out in September—actually there was not—I think there may be some misunderstanding of dates here.

First of all, this study of the SBIC Program in two phases was commissioned, if you will, in September. The phase 1 study which is well along in the implementation process was completed in December. The phase 2 study which deals with the SBIC operations was just completed and an implementation plan was formulated in April. So, we are just at the beginning of implementing those recommendations.

The **Chairman**. In Mr. Hertzberg's testimony, perhaps I should direct this to him, it says Ms. Engeleiter announced on September 1 the formation of a management team to review the entire SBIC liquidation function. An outside contractor was commissioned to review the liquidation process and the adequacy of the Agency's resources. And you say a draft of the contractor's study report was issued in January; it provided a number of recommendations. Now, I have asked you about the first one of those recommendations.

Mr. **Hertzberg**. Mr. Chairman, the study was done in two separate phases. The first phase dealt with the liquidation of SBICs and they were the ones that were in active liquidation at this time. The second phase of the study, the one that Mr. Lineberry refers to, has been just recently completed; it was that second phase that looked at the licensing and the procedures involved in the evaluation of new licensees and the monitoring of active SBICs.

The **Chairman**. Well, my question is: What is the management team of SBICs doing to go behind the facade of the value of these companies and try to figure out what these companies are really worth so you can determine the viability and the financial health of the SBICs? We both agree that you cannot determine that until you know the value of the companies.

Mr. **Hertzberg**. I think one of the key things that has to be done is the on-site visitation that we referred to; that will take resources. In the meantime, we are going to have to look more carefully at the financial statements and find a way to use existing personnel to make the on-site visits.

Mr. **Lineberry**. Senator, as I indicated we have put procedures and resources in place in the form of computer hardware and software to take a much closer and more uniform look at financial statements and take some of the judgment factor out of it on the part of individual staff members.

The CHAIRMAN. I have other questions, but other Senators need to be able to ask questions; some of them have other schedules. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

In your written statement you cited a number of factors which are responsible for contributing to the upturn in the number of SBICs which were liquidated. I would like to have you expand on how these events affect the SBIC Program. But I am particularly interested in knowing how the 1986 repeal of the income tax exclusion on capital gains adversely affected the program.

Mr. HERTZBERG. I think that that was kind of a reasoned guess at what might have caused some difficulty. I missed that in my oral statement. I think that perhaps it may have caused some difficulties in the SBICs in realizing their investment—their options to turn investment opportunities into profits. I believe Mr. Lineberry can comment on that.

Mr. LINEBERRY. Senator, it is hard to quantify what happened, but what we have observed anecdotally is obviously that SBICs that were equity investors were not able to realize the after-tax gain on those investments that they might otherwise. Or, in some case, they rushed to liquidate equity positions prior to the end of 1986 to take advantage of the capital gains tax exclusion that was available until then.

I think, however, it has to be put into perspective as one of a number of factors, because another thing that collapsed about the same time was the high-tech, early stage investment market. And again, the capital gains exclusion may have had something to do with problems in the initial public offerings market, which had been a profitable exit vehicle for investors in those types of companies.

Senator GRASSLEY. Additionally, in your statement you respond to the GAO's recommendations that independent accountants performing SBICs' audits should follow generally accepted Government auditing standards by saying that adhering to these standards would duplicate work already performed by the Inspector General, and impose a significant burden of increased expense on the SBIC being audited.

Can you tell me what improvements in the SBIC Program did GAO think would result if these auditing standards were used by the independent auditors?

Mr. HERTZBERG. I have not looked at that in great detail, so I cannot do that. But I think that the idea was that the independent auditors would do some of the compliance work. That is the part that we feel is duplicative and unnecessary, particularly in a case like River, where they failed to do the financial side of the audit the way that we think they should have.

Senator GRASSLEY. Well, despite your disagreement with the recommendation, do you believe that changing auditing practices will remedy or prevent any SBIC problems?

Mr. HERTZBERG. Changing auditing practices?

Senator GRASSLEY. As recommended.

Mr. LINEBERRY. Senator Grassley, it is always possible, but the type of problem that we are talking about here is a financial auditing problem. The GAO recommendations really dealt with the compliance type of audit. And that is an area that we feel strongly has to be performed either by employees of the Agency, such as the Inspector General's auditors do now, or by independent auditors who would be under contract to the Agency, and not the independent auditors who are engaged by the SBICs themselves to do the financial audits.

So there is a very important side issue that runs counter to that recommendation.

Senator **Grassley**. You also state that in the case of River Capital, auditing standards had little to do with their problems, but rather, portfolio valuations and "the extent to which both independent auditors and the IG examiners verified the representations of management."

What has been done to ensure that these two problems do not occur with other SBICs?

Mr. **Lineberry**. Well, again, it comes back to the question that Senator Bumpers was asking, which runs to our ability to go out and take a look at the portfolio assets of SBICs. In other words, that is really the weak point in the process. And I might add, it is not a weak point in every case. We are talking here about some questionable audits. Obviously that does not happen all the time. But where it does happen, as we see with River Capital, there can be serious consequences.

And then, the other thing that we have done in the meantime is to tighten and put in better financial evaluation procedures so that we can hopefully better spot deficiencies and inaccuracies in information that we do receive.

Senator **Grassley**. You may be aware that Chairman Bumpers, at last week's hearing, proposed that perhaps SBA needs to suspend the licensing of additional SBICs until we get the bugs worked out of the programs. What is your opinion of that proposal?

Mr. **Lineberry**. Well, Senator Grassley, I feel that that is not a necessary step. We do have a number of license applications pending. However, we do have some things in place and underway that we feel will address the problem. And that could very well happen before we would get to a point where these companies have been licensed and have invested their private capital so that they might be coming to us for SBA guaranteed funding.

However, and maybe I anticipate something here, but there was another proposal to go out and take a close look at companies. And again, we have taken a look at the SBICs and MSBICs, and it appears to us that by taking a close look in the very near future at approximately 60 SBICs, we would be looking at over half of the Government's present financial exposure.

That is something that we are interested in doing. We feel that that part of the suggestion is a very appropriate one, and we feel could be doable.

Senator **Grassley**. Thank you, Mr. Chairman.

The **Chairman**. Thank you very much.

Senator Lieberman.

Senator **Lieberman**. Thank you, Mr. Chairman.

Mr. Hertzberg, gentlemen, in hearing the story unfold last week and in listening today—and I say this respectfully and please correct me if you think I am wrong—I find in your reaction what I would call a surprising degree of tranquility. Or let me put it another way, you seem to be trying to put the best face on a situation that, to me, last week looked pretty horrible.

And just as one example of it, in your own assessment, Mr. Hertzberg, in your statement today about the condition of the SBIC industry, you say that approximately 15 percent of the SBICs were in unsatisfactory financial condition, while 85 percent were in acceptable to strong financial condition. That does not look too bad. But, I believe that omits the 170 that are already in liquidation, which would bring the total much closer to 40 percent of the SBICs in trouble, rather than the 15 percent. Am I wrong?

Mr. **Hertzberg**. No, you are not wrong. Of course these have already gone into the liquidation category. And I think that our attempt here was to assess those that are left.

Senator **Lieberman**. Currently. OK. But do you agree with me that the 15 percent of those that are out there now, in addition to the 170, represents a serious rate of trouble? Again, I say this with a prevailing feeling of sadness or poignancy, because this is a great program on paper, and people had hopes. And I know that many of the SBICs have done great things. I am just unsettled and outraged by the fact that 40 percent have gotten in trouble.

Mr. **Hertzberg**. We are concerned, and I think that that is why we are looking at ways to improve the monitoring of those that continue to be active.

Bob, would you like to add to that?

Mr. **Lineberry**. Well, Senator, the fact that 15 percent are in substandard to poor condition is a matter of great concern to us. I would not want to minimize that in any way. And we are working to take a closer look at those companies and to have better monitoring procedures in the future than we have had in the past.

I would, to try to just maybe put things in a little bit of a perspective, indicate to you that in looking at what we have in liquidation and the expected loss rate on those, that we would come out with a loss rate of about 9.5 percent against the total funds disbursed over the course of the program during its 30-some years of existence.

Now that loss rate, for better or worse, is about comparable with what our loss rate is in all of the business loan programs. And I would just couch that by saying that the SBIC Program is considered to be a higher risk program because of the types of companies that SBICs invest in, and because of the fact that they are taking equity positions or subordinated debt positions in a lot of cases.

But there are things that we can do and that we want to do to give us a little better handle on what is going on out there with the portfolio companies.

Senator **Lieberman**. OK. Help me understand that number in regard to those presently in liquidation. Because one of the numbers we heard last week, and I believe this is correct, that of the 170 SBICs that have been liquidated or in the process of being liquidated, there was a total exposure to the Government of over $½ billion. I believe it was $560 million, I am not sure of that exact number.

So tell me how much of that you estimate we will be able to recover.

Mr. **Lineberry**. Well, it is estimated that a little over 60 percent will be recovered. And that is based on the historic loss rate. And that loss rate does factor in experience with some big cases and a lot of small ones.

Senator **Lieberman**. So that says you would recover about $300 million, roughly, and that we would lose about $200 million?

Mr. **Lineberry**. Well, I guess perhaps Mr. Chambers could give you the exact numbers on that. But they expect the total loss to be considerably less than the $500 million.

Senator **Lieberman**. Mr. Hertzberg, did you want to add something?

Mr. **Hertzberg**. I would like to throw in that I do not know that we can expect that the 62 percent rate will continue now, particularly facing one like River Capital.

Senator **Lieberman**. Sure.

Mr. **Hertzberg**. With a total loss of $28 million, that could have a very substantial effect on that percentage of recovery that we have enjoyed in the past.

Mr. **Chambers**. Senator, the figures up through the end of March, there is $480 million in liquidation. We expect to recover about $266 million, and we expect to lose $214 million.

Senator **Lieberman**. All right, I appreciate having those numbers.

Now, Mr. Lineberry, that makes me concerned about the number you used before, because I believe it is a bit illusory. But let me understand it. Was it 9 percent you used before as a loss?

Mr. **Lineberry**. That would be about right.

Senator **Lieberman**. So you would take that over the total amount of Federal Government involvement in SBICs over the 32-year history?

Mr. **Lineberry**. That is the way the loss rate is measured.

Senator **Lieberman**. So is that taking that $200 million, and then making that the percentage over the total amount expended, or is it the $200 million plus all other losses you have had over the 35-year period?

Mr. **Lineberry**. Well, the total losses, because there have been losses already taken, and then what Mr. Chambers is talking about is additional losses anticipated. Or another way to look at it is recoveries not realized, measured against the total of $2.94 billion that has been disbursed, would work out to about 9.4 percent of that amount as an ultimate loss rate.

Senator **Lieberman**. OK. But obviously, the more than $200 million loss is a significant amount of money for the taxpayers.

Mr. **Lineberry**. It certainly is.

Senator **Lieberman**. I want to come back on one other point. In fact, I apologize, Mr. Chairman, I have to depart in a minute.

The **Chairman**. Take your time and go ahead.

Senator **Lieberman**. On the EWE case, again, last week, and this goes to you, Mr. Chambers, because you indicated earlier, if I recall, in response to the Chairman's question, that there would be a net from EWE of $8 million. Now I heard that to say that we would come out with $8 million more than we put in, or that we would recover it. Because last week the IG, and I will read from his report, said that we estimate that SBA will lose between $11 million to $15 million on EWE. And that EWE has spent over $10 million to develop and operate the ski resort, and so forth.

So I presume that the net for the U.S. Government on EWE will be minus. Is that correct?

Mr. **Benderson**. Yes.

Senator **Lieberman**. In other words, we are not going to get back as much as we put in?

Mr. **Benderson**. Right. As I understand your question, you are asking Mr. Chambers since the Government lent Royal the principal rather than EWE, $18 million, and another $5 million in interest, are we going to recover $26 million as opposed to $18 million? No. We are going to recover $8 million against the $18 million.

Mr. **Chambers**. In addition to that, right after we were put in receivership in the Southern District of New York in the summertime in 1982, we were in a position at that point to go and complete some contracts, and there was $3.5 million. We actually put about $5 million, as I recall, into completing those contracts. We have recovered that, and that has been paid back to the Treasury.

When I said $8 million net, that means that we paid back the Treasury what we borrowed, in effect, with receiver certificates in the summer and fall of 1982, to complete the contracts out in Westwood, CO. That has been paid back. In addition to that, we estimate that we are going to recover $8 million of the original $18 million.

Senator **Lieberman**. OK. All right, I understand. So we are still going to be out about $10 million, and perhaps a little bit more if you count the interest?

The **Chairman**. And accrued interest, I think you said.

Senator **Lieberman**. Right. So we will be out about $15 million.

A final question, and again, as I listen to the IG's testimony last week and read the report, what the three SBA employees did with regard to setting up EWE seemed to me to be startling; it was just outside of the regular purview of Government. And yet in your response today, and, Mr. Hertzberg, in a memo that the Committee has that you are familiar with, of June 23, 1989, to Mr. Holloway, you deny that any loss will be incurred because liquidation officials ignored public laws or Federal regulations, and you attribute it basically to changed economic conditions and our authorized judgment which had to be made on the basis of the information available.

So that is a very different view. And of course we were troubled last week that nobody higher up had a word of approval on that. Maybe I should ask you, if they had asked you about this, would you have authorized them to go ahead?

Mr. **Hertzberg**. I cannot say at this point; I cannot put myself in that position. However, I view this as a ministerial kind of thing. I understand what the Chairman has said, that this is a Government corporation, so how can it be denied. I do not think anybody is denying that the Government owned this corporation, and that the Government formed this corporation.

And I am not a lawyer and I am probably stepping on someone's toes, but the full meaning of the Corporation Control Act, as I understand it, is that we are precluded from forming a corporation that would act as an agency. And I think that that is the key difference here. The corporation that was formed simply was ministerial in nature to make the 40-some bank accounts easier to manage, and to find a way to deal with the operational things that had to be dealt with. And I think that they did.

Senator **Lieberman**. Well, EWE was unprecedented, was it not? It never occurred before in your experience with SBA?

Mr. **Lineberry**. Yes, I would agree with that.

Mr. **Benderson**. I wonder if I could say a few things if you have the time, Senator.

Senator **Lieberman**. Yes, sure.

Mr. **Benderson**. Let me answer your concerns one by one as I understand them. First of all, our point is that the losses that result from the Royal liquidation, and there will be losses, probably in the range of $10 million—are not the result of EWE's formation or operating "outside the laws" or "circumvention of the laws." When it went into liquidation and into receivership, Royal had 11 subsidiary corporations. One of those 11 subsidiary corporations owned the ski area.

EWE, and I think this is what Mr. Hertzberg meant, was somewhat of secondary importance in the sense that whether there was an EWE or not an EWE, we were faced with operating 11 subsidiary corporations. Royal was basically a holding company that was operating all its assets, which were mainly real estate, through these 11 subsidiary corporations.

At the time EWE was formed—and I will tell you in retrospect, with the controversy it has created, I do not think anybody in the agency would ever do this again, and not necessarily because I feel that it was improper or illegal, but because it totally detracts from what actually happened, which was the attempt to run 11 subsidiary corporations in an orderly manner that had very sophisticated, tangled, complicated investments—Royal was taken out, and I am trying to be very brief—out of receivership prematurely.

Like a bankruptcy, most receiverships result in a complete liquidation of the assets and a distribution to creditors. Because of a very vicious battle with a controlling shareholder of this company over a period of years that resulted in a Court of Appeals decision saying he could not put it in bankruptcy and wrest control of Royal out of the receivership, we wanted to get that away from him because quite frankly, the receivership operations were being paralyzed by this exhausting, time consuming, and costly battle.

So we formed EWE to replace Royal in order to manage these 11 subsidiary corporations. But, again, I emphasize that it was of secondary importance, because the assets were held by the subsidiary companies, and SBA was faced with operating the subsidiary companies. EWE facilitated it. The loss resulted from the collapse of the Colorado economy, particularly in the ski area, and not as the IG alleges, which is totally fallacious, a result of mismanagement.

Senator **Lieberman**. Well, I appreciate the answer. I would like to continue this, but I do not think there is an opportunity to do it.

Thank you, Mr. Chairman.

The **Chairman**. Senator Lieberman, while you are here, I just might say for the record that the Corporation Control Act, I just do not see how you could have anything any clearer than this.

Now I have read—is it Sally Narey, I do not mean to be hypercritical, but I read her legal opinion of this, which I found to be one of the most absurd legal opinions I ever read in my life. I mean it made no sense whatsoever.

But the Government Corporation Control Act says an agency may establish or acquire a corporation to act as an agency only by or under a law of the United States specifically authorizing the action. And I have said that 100 times, and the mother tongue is English, and I do not know how English can be any plainer than that is.

And all these obfuscations about, well, it meant mixed Government and Government ownership, and so on, none of that has any merit at all to me.

Mr. **Benderson.** I recognize that. And I met with your staff yesterday and I must tell you I was quite frustrated. There is no question that reasonable minds can disagree on this issue. And I would be the first to admit that it could go either way.

It is almost a question of philosophical import, because the purpose of the Corporation Control Act, if you look at its legislative history and from what it grew out of, which is really the Depression and World War II, and Congress' and the Executive's concern that the Government was operating, from a budgetary standpoint and an oversight standpoint, too much in these private corporations. Congress was concerned about this, and so they passed this act.

But they put in this language—and this is what I would ask the Chairman to consider—the qualifying language, "to act as an agency." And I think what that means is that it does not prohibit—I think there was a recognition by Congress that the Government, whether it is, in modern times, as a lender, or what have you, is going to be in situations where it may need a corporate vehicle to add flexibility, particularly in the situation that SBA faces, in terms of liquidation.

If this EWE, or whatever corporate entity you wanted to create, were to carry on general functions of an agency, then I would agree with you, Mr. Chairman, it would be illegal. But I would just ask you to concede to me that this qualifying language, "to act as an agency", raises a question about EWE's legality for the simple reason that EWE simply replaced a private commercial company, Royal Business Funds Corp., to hold and liquidate subsidiary corporations.

And again, I get back to the issue that I raised before about "acquire." The act says "establish" or "acquire." We are talking about "establish." I would say to you that if you want to read "establish" as expansively as you, you have to read "acquire" as expansively as you have "established." Therefore, you could have acquired the 11 subsidiary corporations which, roughly at that time, represented $25 million in assets to the Government.

Now I know that there are arguments on the other side of that, too. But all I ask is that you concede that this is a difficult question, and what I resent, quite frankly, about the IG's audit report, is what it makes it out to be—and I have heard Colombian drug cartels described more charitably than what three Government employees who were working day and night, struggling with a liquidation, were trying to accomplish—which is absolutely ridiculous.

We were not trying to violate the law. At best, there is a serious question here, a serious legal issue, that the greatest legal minds in the United States could disagree on, and it is not an easy issue to resolve.

I, quite frankly, would feel very comfortable arguing to a court of appeals this issue, and I think I would win it. The Justice Department has the issue, and I cannot say anymore.

The **Chairman**. I think you would lose hopelessly.

Let me ask you this. Did you abide by Government disbursing rules? Did EWE abide by Government disbursing rules?

Mr. **Benderson**. No. And the reason it did not, it was operating businesses. For example, if you take the ski area, what we would do under the miscellaneous receipts for the Treasury, if they applied, and I would take the position that they do not apply, but if they applied, every time you sold a hamburger or a lift ticket you would have to turn that over to your Treasury account to miscellaneous receipts.

The **Chairman**. By what authority did EWE tap—here is a corporation set up by three officers of SBA, and you spend $5 million putting money into these two projects, admittedly for a valid cause, trying to salvage something out of it, but by what authority did you tap the U.S. Treasury to do that?

Mr. **Benderson**. Well, first of all, we did not tap the U.S. Treasury to any great——

The **Chairman**. Where did the money come from?

Mr. **Benderson**. It came from the assets of Royal, and there was a reason for that. But the $5 million that you are directing yourself to pretty much is what was put in during the receivership, not at the time that EWE was formed.

Let me just go back.

The **Chairman**. I hate to interrupt you, but I am going to have to run to vote. If you all will just stand at ease for a few minutes, I will be right back. We will stand in recess for about 10 minutes.

[Recess.]

The **Chairman**. We are going to have a series of votes, so I may have to submit most of the rest of my questions in writing, gentlemen.

Let me ask you a question about River Capital. And this really is more for the IG, but Mr. Lineberry and Mr. Hertzberg might be able to shed some light on it. How can there not be some either gross negligence or downright culpability on the part of River Capital's officers and directors for them to allow Arthur Andersen to send you the kind of draft audit you got, and then, 8 months later, for them to be in liquidation?

Mr. **Hertzberg**. I am not sure how that responsibility would come down on them. I would like to ask Mr. Benderson, perhaps, to comment on that, because I think there are some legal implications to it.

Mr. **Benderson**. Well, let me put it this way, if I were the officers or directors of River Capital I would not be sleeping well tonight.

The **Chairman**. Well, that is a good answer.

Because this makes no sense to me. Arthur Andersen is one part of this story, but when Arthur Andersen said that we just used the good faith estimate based on representations of the directors in a board meeting to decide that these corporations were all in reasonably good health—when in fact I do not see how they could have kept from knowing that they were in fact not in good health.

Mr. **LINEBERRY**. Senator, we do look basically to the officers and directors of the SBICs to properly value their portfolios, to take the write-downs and charge off the losses, so that they accurately reflect the true value of what, for them, is their inventory. Their investments are the same as an inventory, say, in a retail business. And it is up to them to value it properly.

Now, again, what we are seeing in the River Capital case is that there has to be a closer look at what is supporting those valuations. And I do believe that somebody onsite doing the audit and looking for portfolio company financial statements or the absence thereof, and what those statements might tell you about the condition of those investee companies, probably should have seen a much different picture than the audited financial——

The **CHAIRMAN**. Let me ask you this question. Why does SBA always wind up so far down the list? It seems to me that they are subordinated to virtually everybody else. We loaned River Capital $28 million and we wind up with—we are virtually last on the list. The banks, everybody, takes priority over us in a bankruptcy. Why is our loan not better secured? And why do we not have a first lien on whatever assets there are, including the money they put in?

Mr. **LINEBERRY**. Well, Senator, the statute provides that basically we are to be a subordinated creditor. It does not articulate just how subordinated we have to be. The Agency, though, since the beginning of the program, has interpreted that statute to mean that we basically are subordinated to everybody except the insiders. In other words, except the private capital and perhaps loans by officers and directors.

The **CHAIRMAN**. Can you give me one good reason for us to be subordinated to everybody else? I mean we loaned somebody like River Capital $28 million, they put in $7 or $8 million, then they go borrow from the bank and the bank takes precedence over us.

Mr. **LINEBERRY**. That has been a problem in a few cases. It has not arisen in this magnitude in very many cases prior to this one. However, we are working on a package of regulatory proposals that are going to be coming out of the Agency shortly.

One of the things that we are looking at dealing with is a limit on what types of creditors of the licensee SBA will be subordinated to, and also, without our express prior approval, how much, in terms of dollar amount, we might be subordinated to. So that is something that is under consideration right now.

The **CHAIRMAN**. Now, Mr. Hertzberg, you have listed the SBICs that are in difficulty. And I must say I thought Senator Lieberman was on to something: That we have 170 in liquidation and another 15 percent in trouble. That is a really lousy record in my books. If we are just talking about in the history of this thing, having lost 15 percent of the SBICs, that would be one thing. But when you add all of them together you come up with a very high default rate—an unacceptable default rate.

Now let me ask you this. Among those that you consider to be in serious difficulty, do you include Clinton Capital Corp. and Columbia Capital Corp., which is a MSBIC? Are you familiar with that?

Mr. HERTZBERG. Yes.

Mr. LINEBERRY. Those have already been transferred to liquidation.

The CHAIRMAN. They have been transferred to liquidation?

Mr. LINEBERRY. Yes, they have.

The CHAIRMAN. Now, what was the relationship between a gentleman named—is it Sharfman?

Mr. LINEBERRY. Well, Mr. Sharfman is the principal in both of those SBICs.

The CHAIRMAN. In both of those SBICs?

Mr. LINEBERRY. That is correct.

The CHAIRMAN. And he had loaned $38 million to Mr. Gan. Now what is our exposure in those two SBICs?

Mr. LINEBERRY. Well, Senator, the exposure is about $38 million.

The CHAIRMAN. Is that what we had loaned those two?

Mr. LINEBERRY. In the two SBICs, yes, sir.

The CHAIRMAN. And do we have some hanky-panky going on in those two?

Mr. LINEBERRY. Senator, if you would like to go into any specifics about those two cases, I would respectfully request that we go into closed session, because there is a criminal investigation going on.

The CHAIRMAN. Do you have any idea what, if anything--are we again subordinated to everybody else? Are we going to lose our whole $38 million?

Mr. LINEBERRY. We do not really know what the losses will be, I do not believe. Perhaps Earl would want to add something to that.

Mr. BENDERSON. In the case of Clinton Capital Corp., Citicorp is ahead of us to the tune of $65 million. The assets have a value anywhere from $90 to $110 million. I am optimistic, and I could be wrong, but I am optimistic we will get a large percentage of our indebtedness back. The principals have been cooperative with us in trying to work these problems out. And we have had a number of meetings with Citicorp.

My own personal estimation is that I think River is the biggest loss, which, as I say, it is zero. I think we will get a substantial recovery from this. The problem in the Clinton case, as best I can tell, is simply that the real estate market in New York has collapsed, and they were leveraged to the hilt. And I think that is what the problem is. I think the principals are desperately trying to come to an accommodation in good faith in trying to work out the indebtedness with us and Citicorp. And I think we will get a substantial recovery.

The CHAIRMAN. I would like for staff to visit with you gentlemen. I do not have time for a closed session here, but I would like to get the details on those two.

Mr. LINEBERRY. We would be happy to do that.

The CHAIRMAN. And my next question is, you did not list those as a part of those that are still operating, then?

Mr. LINEBERRY. That is correct.

Mr. HERTZBERG. When we talked about the SBICs that we had evaluated as of September 15, 1989, they were included in that number. As we talked about the number in liquidation subsequent to that date, that included Clinton and Columbia.

The CHAIRMAN. OK.

Gentlemen, we will submit some additional questions to you, but I want to make two points.[3] No. 1, it may not be good business to declare a moratorium on licensing additional SBICs, but I can tell you, based on what I have learned so far here, I think there should be a moratorium until you can assure this Committee that you have auditing procedures and investigative procedures in place, and that you can absolutely assure this Committee of a number of things, not the least of which is that we are not going to be subordinated to everybody else.

No. 2, that we are going to go behind the draft audits. For example, I do not know why you could not ask an SBIC to submit an audited or unaudited financial statement on each of the corporations it has invested in, and let those corporations, when they send their financial statements to the SBIC, let them swear to it, so that there can be a criminal prosecution if it turns out to be false, and no questions asked.

I mean we have to figure out—I have a feeling we have a much bigger exposure than we are talking about. Now, Mr. Hertzberg, you listed $480 million; that is at variance with the IG's figure. I do not know what the difference is or how you arrived at those figures.

Mr. HERTZBERG. There may be a time lapse between the two figures.

The CHAIRMAN. It is a substantial amount of money either way. And for us to be going along here and all of a sudden find ourselves with a $½ billion loss in this program, all these companies going belly up, and not knowing the condition of the remainder of them is absolutely unacceptable. We cannot have it. And, personally, I do not have the ability to get a law through here, but Ms. Engeleiter has the ability to declare a moratorium on any additional ones administratively, and she ought to do it until we get to the bottom of this.

Thank you very much.

The Committee is recessed.

[Whereupon, at 3:45 p.m., the hearing was recessed.]

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[3] Questions and answers appear on page 106.

SBA'S SMALL BUSINESS INVESTMENT COMPANIES PROGRAM

THURSDAY, JUNE 21, 1990

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 9:39 a.m., in room SR-428A, Russell Senate Office Building, Hon. Dale Bumpers (Chairman of the Committee) presiding.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

The CHAIRMAN. The Committee will come to order.

This morning the Committee begins the third of four hearings on problems in the Small Business Investment Company Program. We previously heard disturbing testimony from the IG concerning the quality of public accounting firm audits performed on River Capital Company, which defaulted on $28.5 million in SBA guarantee debentures in 1989 and subsequently filed for bankruptcy. River Capital remains the largest failure in the history of the program and represents a significant portion of the $563 million which failed SBICs now owe the Government.

In previous discussions with Inspector General Gillum, I have questioned whether the Congress can have any real confidence in the audits performed on the 444 active SBICs, if the work submitted in the River case was truly as flawed as he reported.

I am glad to say that the IG has volunteered to undertake a quick study of 50 additional licensees, which represent in the aggregate some two-thirds of outstanding SBIC leverage in an effort to determine whether additional significant problems are looming just over the horizon. Mr. Gillum will present the results of that study today.

Unhappily, I expect the Inspector General will report that there is, indeed, additional cause for concern. While it should be emphasized that his results are tentative only, some 13 of the 50 companies he has reviewed show significant red flags which will require additional scrutiny by the Administration. Many of the issues may be resolved favorably, but it concerns me greatly that 13 more active SBICs, representing an additional $160 million in exposure to the taxpayers, may be at significant risk on top of the over one-half of a billion dollars owed by the 170 companies in liquidation.

Incidentally, I want to congratulate the Inspector General again on uncovering the bizarre case of EWE Properties Limited, which was established by SBA to liquidate a failed SBIC. The IG found this scheme violated the clear language of the Corporation Control Act. SBA's General Counsel disagreed and sought to justify EWE. And Administrator Engeleiter submitted this dispute to the Department of Justice, and I understand the Attorney General has just issued an opinion upholding the IG and overruling the General Counsel.

Next, the General Accounting Office will present the results of its review of the work done by Arthur Andersen and Company in the River Capital case. Arthur Andersen has cooperated with the Committee and with GAO in this review. The accounting firm will then have an opportunity to respond to the GAO findings. I have also asked both GAO and Arthur Andersen to share with the Committee any policy recommendations which they may have concerning programmatic changes to improve the reliability of financial information on SBICs.

Finally, I want to say that comparisons between this situation and the savings and loan calamity are not justified as yet. However, I have been deeply troubled by the political highjinks this week on the part of the Administration in seeking to shift blame for the S&L debacle to the Democratic Members of Congress, including one who was not even in office when the ship went down.

This Committee did not commence these hearings with any political agenda, but simply an exercise of its oversight and legislative duties. Thus far, however, I have been disappointed in the Administration's response to this situation, which has bordered on denial of the problem.

The Committee will be obligated to address the problems which have been uncovered here one way or another. Once again I asked the Administration to cooperate with us, as the SBIC industry and the public accounting professions have, in seeking reasonable and thoughtful solutions. This is not time for politicking, and the record will be clear that this Committee is prepared to face reality on this situation.

Senator Grassley.

STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Mr. Chairman, I am not going to read an opening statement. I ask that it be submitted. I will not be staying around for the hearing because of a conflict in my schedule.

[The prepared statement of Senator Grassley follows:]

STATEMENT OF SENATOR CHARLES GRASSLEY
SMALL BUSINESS COMMITTEE HEARING
SMALL BUSINESS INVESTMENT COMPANIES
JUNE 21, 1990

Mr. Chairman:

Thank you for holding this additional hearing regarding SBA's Small Business Investment Company (SBIC) program. I welcome this opportunity to further examine this program.

SBIC's traditionally have been a great resource for the small business community in helping provide much-needed venture capital for high-risk small companies. As I have stated during our previous hearings, I am concerned about the health of the SBIC program. I believe that even the appearance of misuse of taxpayers dollars needs to be eliminated.

I hope our efforts will result in remedying the short-comings in this worthy program. And, the program will be improved so that it becomes an even greater asset to our nation's small businesses.

I appreciate Inspector General Gillum's appearing before us again. I look forward to hearing the results of his review, as well as hearing the insights the other witnesses may have regarding the SBIC program.

The **Chairman**. Thank you, Senator Grassley. Your statement will be entered in the record and, of course, you are certainly free to submit questions in writing to any of the witnesses.

Senator Kerry.

STATEMENT OF HON. JOHN F. KERRY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator **Kerry**. Mr. Chairman, thank you very much. I am also not going to make a statement or submit one in writing. But I do just want to say that over the 32 years of the history of this program, it obviously has some notable successes, from Apple Computer to Federal Express, and so forth. And I think the concept of a venture capital guaranteed assistance plan is, obviously, a good one, which we have mostly been supportive of.

Needless to say, the signs on the horizon are very troubling. And the kinds of liabilities that we are seeing at a time when we are facing the S&L crisis and considering the contingent liabilities of extraordinary proportions as a result of other guarantee programs force us to look at this quickly and carefully.

And I applaud you, Mr. Chairman, for doing exactly that and for trying to get a check on exactly where we are before yet another disaster looms.

I, unfortunately, have a hearing of the Banking Committee which I requested, along with Senator Dodd, on the credit crunch. And we have Mr. Seidman and Mr. Greenspan and others appearing before us. So I am not able to stay right now.

The **Chairman**. I thank you very much for your remarks, Senator Kerry.

Mr. Gillum, would you please commence your testimony.

STATEMENT OF CHARLES R. GILLUM, INSPECTOR GENERAL, U.S. SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY PETER L. McCLINTOCK, ASSISTANT INSPECTOR GENERAL FOR AUDITING, AND LESTER W. GARTON, DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDITING, SBA

Mr. **Gillum**. Mr. Chairman, I have submitted a statement for the record and have a summary here that I can present or submit the whole statement.

The **Chairman**. That is fine. Your full statement will be inserted in the record, and we will be happy for you to summarize it.

Mr. **Gillum**. All right, sir.

Good morning, Mr. Chairman and Members of the Committee. I am here today in response to your letter of June 12, 1990, inviting testimony on the results to date of a study being prepared by my office on the viability of valuation practices of certain small business investment companies. My comments represent my views and those of the Office of Inspector General and not necessarily those of the Administration. My statement has not been reviewed or coordinated with OMB or the Agency.

With me today is Peter L. McClintock, Assistant Inspector General for Auditing, and Lester W. Garton, Deputy Assistant Inspector General for Auditing.

As you know, my office undertook a study to quickly assess and followup on indicators of SBIC valuation practices. Our study was initiated as a result of questions and concerns posed to us by you, Mr. Chairman, at our last hearing with respect to whether those SBICs rated as average or below in risk, those being 1, 2 or 3, had valuation problems.

To answer this question, we have constructed a study which would not be overly staff intensive, time consuming, or costly. Our study has been divided into five major phases: Planning, data collection, field testing, analysis of results, and report preparation.

The first three phases are substantially complete, and as we discuss them with you today, I want to continually emphasize that the scope of our study has and was, by design, very narrow. And given the preliminary nature of our work to date, I want to urge caution in rushing to conclusions about what the data may be telling us.

In the planning phase, we identified available data including SBA form 468, which might provide an indication of valuation problems. We then stratified our universe to focus on 50 SBICs that individually had leverage of $5 million or more and collectively had leverage totaling about $575 million. This amount represented 48 percent of the total SBA outstanding leverage for all 400 SBICs and about 60 percent of the leverage for those companies rated as 3 or less.

In the data collection phase, we assigned experienced auditors to review the annual financial statements and related materials located in the Investment Division file. From this effort we were able to classify the SBICs under review into three groups: Those with no significant indicators of valuation problems, those with moderate indicators that would justify additional inquiry and those with substantial indicators that would require further followup.

Initial results were that 27 SBICs with related leverage of $269 million had no indicators of problems, 10 SBICs with leverage of $175 million had moderate indicators and 13 SBICs with leverage totaling $131 million had substantive indicators of problems. And these problems included: High loan delinquency rates, negative cashflow, substantial amounts of accrued deferred interest on loans; delinquent loans valued at cost, assets acquired in liquidation valued at cost; and substantial amounts of unrealized appreciation.

Again, I would like to make it clear that these are just indicators and do not necessarily mean that a company is in financial trouble or that its investments are improperly valued.

In the field-testing phase, our third phase, we selected five companies for field visits. Three of the five were in the significant indicator category, and two were in the moderate category. We obtained the most current available information from the SBICs' portfolios, reviewed the SBICs' valuation policies and reviewed the CPAs' most recent working papers pertaining to valuation.

One of our field visit followups is still in process. Our assessments of the other four are that: One SBIC with SBA leverage of $5.4 million has severe financial problems; one SBIC with SBA leverage of $5 million is in a questionable financial position; one SBIC with SBA leverage of $12 million is in a questionable financial position; and in the fourth, from the field testing, it does not look like there appears to be any potential risk.

Based on the results of our efforts to date, we believe that: 1, Further review is needed of these SBICs that had moderate and significant indicators, and we will address these needs in our forthcoming report. 2, Additional attention is warranted in the areas of SBIC financial condition and adequacy of portfolio valuations. In this latter regard, we have:

Issued instructions to our own staff that will result in additional coverage of valuation issues during our audits of SBICs.

We have filled a new high-level staff position to begin a program of monitoring and doing quality assessments of the work performed by CPAs of the SBICs. And this person will be on our rolls by July 2 and will get our program up and running by August 1.

We have provided our initial observations and the results of our field work to date on the valuation assessment project to the Investment Division for appropriate action. We expect to follow this up with a draft of our written report for their comment and advice, since at this stage we expect that the report will contain recommendations or issues for consideration by both the Office of Inspector General and program officials.

Also, due to the interest of the Administrator, we have begun a second valuation assessment project directed at that universe of SBICs already ranked by the Investment Division as being highly vulnerable from a financial or regulatory viewpoint. This study will generally conform with the methodology of our first study and will enlist the volunteered support of Investment Division persons.

Lastly, the Investment Division is acquiring the services of a contractor to perform independent valuations of companies where questions arise about the adequacy of valuation processes. We are planning to use the contractor's services as a part of the methodology of our second study.

We are continuing to complete our first study and anticipate issuing a draft report during the week of July 9 and will ask for expedited comments from the Investment Division, so that we can issue the final report by August 1. We will provide the Committee with a copy of the report. And our second study began this week, the initial phase of which is targeted for completion within 2 to 3 weeks. We expect to complete that second study within 90 days.

I would be pleased to respond to any questions, Mr. Chairman.

[The prepared statement of Mr. Gillum follows:]

SBA
U.S. Small Business Administration Washington DC 20416

STATEMENT OF
CHARLES R. GILLUM
INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
U.S. SENATE
COMMITTEE ON SMALL BUSINESS
JUNE 21, 1990

GOOD MORNING, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. I AM HERE TODAY IN RESPONSE TO YOUR LETTER OF JUNE 12, 1990, INVITING TESTIMONY ON THE RESULTS TO DATE OF A STUDY BEING PERFORMED BY MY OFFICE ON THE VIABILITY OF VALUATION PRACTICES OF CERTAIN SMALL BUSINESS INVESTMENT COMPANIES. MY COMMENTS REPRESENT MY VIEWS AND THOSE OF THE OFFICE OF INSPECTOR GENERAL, AND NOT NECESSARILY THOSE OF THE ADMINISTRATION. MY STATEMENT, WHICH HAS BEEN SUBMITTED FOR THE RECORD, HAS NOT BEEN SUBJECT TO COORDINATION WITH OR APPROVAL BY THE OFFICE OF MANAGEMENT AND BUDGET OR THE AGENCY.

WITH ME TODAY IS PETER L. MCCLINTOCK, ASSISTANT INSPECTOR GENERAL FOR AUDITING, AND LESTER W. GARTON, DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDITING.

AS YOU KNOW, MY OFFICE UNDERTOOK A STUDY TO QUICKLY ASSESS AND FOLLOW-UP ON INDICATORS OF SBIC VALUATION PRACTICES. OUR STUDY WAS INITIATED AS A RESULT OF QUESTIONS AND CONCERNS POSED TO US BY

THE CHAIRMAN AT OUR LAST HEARING, WITH RESPECT TO WHETHER THOSE SBICS, RATED AS AN AVERAGE OR BELOW RISK (I.E., A 1, 2, OR 3) HAD VALUATION PROBLEMS.

TO ANSWER THIS QUESTION WE HAVE CONSTRUCTED A STUDY WHICH WOULD NOT BE OVERLY STAFF INTENSIVE, TIME CONSUMING, OR COSTLY. OUR STUDY HAS BEEN DIVIDED INTO 5 MAJOR PHASES: PLANNING; DATA COLLECTION; FIELD TESTING; ANALYSIS OF RESULTS; AND REPORT PREPARATION. THE FIRST THREE PHASES ARE SUBSTANTIALLY COMPLETE AND, AS WE DISCUSS THEM WITH YOU TODAY, I WANT TO CONTINUALLY EMPHASIZE THAT THE SCOPE OF OUR STUDY WAS, BY DESIGN, VERY NARROW, AND GIVEN THE PRELIMINARY NATURE OF OUR WORK TO DATE, I WANT TO URGE CAUTION IN RUSHING TO CONCLUSIONS ABOUT WHAT THE DATA MAY BE TELLING US.

PLANNING PHASE

THE PLANNING PHASE BEGAN WITH IDENTIFYING CATEGORIES OF DATA AVAILABLE IN REQUIRED ANNUAL CPA FINANCIAL REPORTS, INCLUDING SBA FORM 468, THAT MAY INDICATE THE POTENTIAL FOR OVER-VALUATION OF PORTFOLIO FINANCINGS. WE COORDINATED THIS PHASE WITH INVESTMENT DIVISION EMPLOYEES TO OBTAIN THEIR IDEAS AS WELL. FROM THIS, WE DEVELOPED A 15 QUESTION WORKSHEET TO FOCUS ON INDICATORS OF VALUATION PROBLEMS AND TO RECORD THE RESULTS OF OUR WORK.

WE THEN STRATIFIED THE SBIC UNIVERSE TO DETERMINE THOSE COMPANIES WE WOULD REVIEW. WE EXCLUDED ALL SBICS THAT HAD A RATING OF 4 OR 5 SINCE THEY ALREADY HAD BEEN IDENTIFIED AS POTENTIAL RISKS. OUR

FINAL UNIVERSE INCLUDED 50 SBICS THAT INDIVIDUALLY HAD LEVERAGE OF $5 MILLION OR MORE AND COLLECTIVELY HAD LEVERAGE TOTALING ABOUT $575 MILLION. THIS AMOUNT REPRESENTED 48% OF THE TOTAL SBA OUTSTANDING LEVERAGE FOR ALL 400 SBICS AND ABOUT 60% OF THE LEVERAGE FOR THOSE COMPANIES RATED AS A 3 OR LESS.

DATA COLLECTION

WE ASSIGNED 3 EXPERIENCED AND KNOWLEDGEABLE AUDITORS, USING THE 15 QUESTION WORKSHEET, TO REVIEW THE ANNUAL FINANCIAL STATEMENTS AND RELATED MATERIALS, LOCATED IN THE INVESTMENT DIVISION FILES. FROM THIS EFFORT WE WERE ABLE TO CLASSIFY THE SBICS UNDER REVIEW INTO 3 GROUPS: THOSE WITH NO SIGNIFICANT INDICATORS OF VALUATION PROBLEMS; THOSE WITH MODERATE INDICATORS THAT WOULD JUSTIFY ADDITIONAL INQUIRY; AND THOSE WITH SUBSTANTIVE INDICATORS THAT WOULD REQUIRE FURTHER FOLLOW-UP.

INITIAL RESULTS WERE THAT 27 SBICS WITH RELATED LEVERAGE OF $269 MILLION HAD NO INDICATORS OF PROBLEMS; 10 SBICS WITH LEVERAGE OF $175 MILLION HAD MODERATE INDICATORS; AND 13 SBICS WITH LEVERAGE TOTALING $131 MILLION HAD SUBSTANTIVE INDICATORS OF PROBLEMS. THESE INDICATORS INCLUDED:

-- HIGH LOAN DELINQUENCY RATES

-- NEGATIVE CASH FLOW

- SUBSTANTIAL AMOUNTS OF ACCRUED DEFERRED INTEREST ON LOANS
- DELINQUENT LOANS VALUED AT COST
- ASSETS ACQUIRED IN LIQUIDATION VALUED AT COST
- SUBSTANTIAL AMOUNTS OF UNREALIZED APPRECIATION

AGAIN, I WOULD LIKE TO MAKE IT CLEAR THAT INDICATORS DO NOT NECESSARILY MEAN THAT A COMPANY IS IN FINANCIAL TROUBLE OR THAT ITS INVESTMENTS ARE IMPROPERLY VALUED. (FOR EXAMPLE, THE INDICATORS FOR ONE OF THE SBICS WERE HIGH, BUT AS DISCUSSED LATER, IN FIELD TESTING WE LEARNED THAT THE COMPANY APPEARS TO BE FINANCIALLY STABLE.) THEY DO REPRESENT CONDITIONS THAT WARRANT FURTHER INQUIRY AND ANALYSIS.

FIELD TESTING

IN THE FIELD TESTING PHASE, WE SELECTED 5 COMPANIES FOR FIELD VISITS. THREE OF THE 5 SBICS WERE IN THE "SIGNIFICANT INDICATOR" CATEGORY AND 2 WERE IN THE "MODERATE INDICATOR" CATEGORY. IN ADDITION, THE INVESTMENT DIVISION HAD A SCHEDULED VISIT TO 4 OF THE COMPANIES THAT WERE IN THE "SIGNIFICANT INDICATOR" CATEGORY. WE ARE HOPEFUL THAT WE WILL BE ABLE TO INCORPORATE THE INVESTMENT DIVISION'S RESULTS IN OUR OVERALL ANALYSIS AND AS PART OF OUR FINAL REPORT.

DURING OUR FIELD VISITS, WE OBTAINED THE MOST CURRENT AVAILABLE INFORMATION ON THE SBICS' PORTFOLIO, REVIEWED THE SBICS' VALUATION POLICIES AND REVIEWED THE CPAS' MOST RECENT WORKING PAPERS PERTAINING TO VALUATION.

ONE OF OUR FIELD VISIT FOLLOW-UPS IS STILL IN PROCESS. OUR ASSESSMENTS OF THE OTHER 4 SBICS ARE THAT:

- ONE SBIC WITH SBA LEVERAGE OF $5.4 MILLION HAS SEVERE FINANCIAL PROBLEMS. THE LICENSEE'S JULY 1989 FINANCIAL REPORT TO SBA SHOWED THAT 55 PERCENT OF ITS LOANS WERE DELINQUENT AND THAT IT HAD A NEGATIVE CASH FLOW. OUR ON-SITE REVIEW FOUND THAT 49 PERCENT OF THE LOANS WERE DELINQUENT FOR MORE THAN 90 DAYS AND THAT THE LICENSEE HAD TO BORROW FUNDS FROM SHAREHOLDERS TO MEET EXPENSES. THE LICENSEE DID NOT HAVE FORMAL PORTFOLIO VALUATION PROCEDURES. OUR REVIEW INDICATED THAT A SUBSTANTIAL NUMBER OF THE INVESTMENTS ARE OVERVALUED. IN ADDITION, AN INDEPENDENT AUDITOR'S COMPILATION, DATED AS OF JANUARY 31, 1990, STATED THE LICENSEE WAS DELINQUENT ON SENIOR DEBT OF $3.5 MILLION AND "CONDITIONS EXIST WHICH RAISE SUBSTANTIAL DOUBT ABOUT THE COMPANY'S ABILITY TO CONTINUE AS A GOING CONCERN."

- ONE SBIC WITH SBA LEVERAGE OF $5 MILLION IS IN A QUESTIONABLE FINANCIAL POSITION. AS OF MARCH 1990, 50 PERCENT OF ITS PORTFOLIO LOANS WERE DELINQUENT FOR 6 MONTHS OR LONGER. THIS SBIC WAS ACCRUING INTEREST ON LOANS DELINQUENT FOR MORE THAN 6 MONTHS CONTRARY TO REGULATIONS. THIS WAS NOT DISCLOSED IN THE CPA'S REPORT. ALL OF THE LOANS ARE COLLATERALIZED WITH CALIFORNIA REAL ESTATE ON WHICH APPRAISALS WERE GENERALLY OBTAINED AT THE TIME OF THE FINANCINGS. WHILE CALIFORNIA REAL ESTATE HAS GENERALLY BEEN HOLDING OR INCREASING IN VALUE, THE CURRENT MARKET VALUE OF THE SPECIFIC REAL ESTATE COLLATERAL HELD WAS NOT DOCUMENTED.

- ONE SBIC WITH SBA LEVERAGE OF $12 MILLION IS IN A QUESTIONABLE FINANCIAL POSITION. THE LICENSEE'S FINANCIAL REPORT TO SBA SHOWED THAT AS OF JUNE 30, 1989 IT WAS 43 PERCENT IMPAIRED AND HAD A NEGATIVE CASH FLOW, WITH 8 OF ITS 15 INVESTMENTS DELINQUENT. OUR ON-SITE REVIEW SHOWED THAT AS OF MARCH 31, 1990 THE LICENSEE HAD ACCUMULATED SUFFICIENT CASH TO SERVICE ITS EXPENSES, BUT STILL HAD A NEGATIVE CASH FLOW. ALSO, AS OF MARCH 1990, THE LICENSEE HAD

DEPRECIATED ONE OF ITS DELINQUENT LOANS, BUT WE OBSERVED NO COLLATERAL FOR ANOTHER DELINQUENT LOAN AND INSUFFICIENT COLLATERAL FOR 2 OTHER DELINQUENT LOANS ON THE POSITIVE SIDE, THE LICENSEE HAD UNREALIZED APPRECIATION OF ABOUT $3.7 MILLION WHICH IS SUPPORTED BY CURRENT PRICES ON A PUBLICLY TRADED INVESTMENT.

- ONE SBIC WITH SBA LEVERAGE OF $35 MILLION DOES NOT CURRENTLY APPEAR TO BE AT RISK FINANCIALLY. AS OF DECEMBER 31, 1989 THE LICENSEE HAD SEVERAL DELINQUENT INVESTMENTS VALUED AT COST. OUR FIELD WORK DISCLOSED THAT THE LICENSEE'S PARENT BANK HAD BEEN TAKEN OVER BY THE FDIC AND THAT ANOTHER BANK SUBSEQUENTLY ACQUIRED THE PARENT BANK'S ASSETS, INCLUDING THOSE OF THE SBIC. WE ALSO NOTED THAT THE NEW PARENT BANK AND THE FDIC HAD ALREADY REVIEWED THE SBIC ASSETS AND HAD WRITTEN THEM DOWN BEFORE THE DECEMBER 1989 FINANCIAL INFORMATION WAS SUBMITTED TO SBA. FURTHER, THE SBIC APPEARS TO HAVE ADEQUATE CASH TO REPAY ITS SBA OBLIGATIONS, WHICH ARE NOT DUE FOR 2 YEARS.

BASED ON THE RESULTS OF OUR EFFORTS TO DATE, WE BELIEVE THAT: (1) FURTHER REVIEW IS NEEDED OF THOSE SBICS THAT HAD "MODERATE" AND

"SIGNIFICANT" INDICATORS, AND WE WILL ADDRESS THESE NEEDS IN OUR FORTHCOMING REPORT, AND (2) ADDITIONAL ATTENTION IS WARRANTED IN THE AREAS OF SBIC FINANCIAL CONDITION AND ADEQUACY OF PORTFOLIO VALUATIONS. IN THIS LATTER REGARD, WE HAVE:

- ISSUED INSTRUCTIONS TO OUR STAFF THAT WILL RESULT IN ADDITIONAL COVERAGE OF VALUATION ISSUES DURING OUR AUDITS OF SBICS.

- FILLED A NEW HIGH LEVEL STAFF POSITION TO BEGIN A PROGRAM OF MONITORING THE QUALITY OF WORK PERFORMED AT SBICS BY CPAS. THIS PERSON WILL BE ON OUR ROLLS JULY 2ND AND WILL GET OUR PROGRAM RUNNING BY AUGUST 1ST.

- PROVIDED OUR INITIAL OBSERVATIONS AND THE RESULTS OF OUR FIELD FOLLOW-UPS ON THIS VALUATION ASSESSMENT PROJECT TO THE INVESTMENT DIVISION FOR APPROPRIATE ACTION. WE EXPECT TO FOLLOW THIS UP WITH A DRAFT OF OUR WRITTEN REPORT FOR THEIR COMMENT AND ADVICE, SINCE, AT THIS STAGE WE EXPECT THAT THE REPORT WILL CONTAIN RECOMMENDATIONS OR ISSUES FOR CONSIDERATION FOR BOTH THE OFFICE OF INSPECTOR GENERAL AND PROGRAM OFFICIALS.

- ALSO, DUE TO INTERESTS OF THE ADMINISTRATOR, WE HAVE BEGUN A SECOND VALUATION ASSESSMENT PROJECT DIRECTED AT THE UNIVERSE OF SBICS ALREADY RANKED BY THE INVESTMENT

DIVISION AS HIGHLY VULNERABLE FROM A FINANCIAL OR REGULATORY VIEWPOINT. THIS STUDY WILL GENERALLY CONFORM WITH THE METHODOLOGY OF THE FIRST STUDY AND WILL ENLIST THE VOLUNTEERLD SUPPORT OF THE INVESTMENT DIVISION.

- LASTLY, THE INVESTMENT DIVISION IS ACQUIRING THE SERVICES OF A CONTRACTOR TO PERFORM INDEPENDENT VALUATIONS OF COMPANIES WHERE QUESTIONS ARISE ABOUT THE ADEQUACY OF VALUATION PROCESSES. WE ARE PLANNING TO USE THE CONTRACTOR'S SERVICES AS A PART OF THE METHODOLOGY IN THE SECOND STUDY.

WE ARE CONTINUING TO COMPLETE OUR FIRST STUDY AND ANTICIPATE ISSUING A DRAFT REPORT DURING THE WEEK OF JULY 9TH AND WILL ASK FOR EXPEDITED COMMENTS FROM THE INVESTMENT DIVISION SO WE CAN ISSUE THE FINAL REPORT BY AUGUST 1ST. WE WILL PROVIDE THE COMMITTEE WITH A COPY OF THE REPORT. OUR SECOND STUDY BEGAN THIS WEEK AND THE INITIAL PHASE IS TARGETED FOR COMPLETION WITHIN 2 TO 3 WEEKS. WE EXPECT TO COMPLETE THIS STUDY WITHIN 90 DAYS.

The **Chairman**. Thank you very much, Mr. Gillum.

Let me ask you first, these 50 SBICs that you took this sort of quick-and-dirty look at, does that represent all of the SBICs who have an indebtedness to SBA of $5 million or more?

Mr. **Gillum**. Yes, sir.

The **Chairman**. All of them?

Mr. **Gillum**. All of them in the category 3, those that initially were rated as average risk or below. As we constructed that first study, and as you will remember during the last hearing, your principal concern was, we know that there are a bunch in the 4 and 5 category and those have already been labeled as risky, and you kept asking me, what do we know about the other category.

So we purposely designed the study to focus on the category of those rated as average or better. We excluded those with 4 and 5, and we excluded the group where there was no leverage. And the whole purpose of the study was, in getting down to the 50, was by design to keep focusing and narrowing it so that we could get it done quickly within the resource availability that we have.

The **Chairman**. Now of the 50 that—did you just send this questionnaire of 15 questions out to them?

Mr. **Gillum**. No, sir. We did that ourselves.

The **Chairman**. You did that?

Mr. **Gillum**. Yes, sir.

The **Chairman**. And you reviewed their last audit?

Mr. **Gillum**. Yes, sir.

The **Chairman**. That had been voluntarily submitted?

Mr. **Gillum**. Yes, sir.

The **Chairman**. Such as in the River Capital case that Arthur Andersen audited?

Mr. **Gillum**. Yes.

The **Chairman**. Is that the kind of an audit that you looked at in these 50 SBICs?

Mr. **Gillum**. Yes, sir.

The **Chairman**. And of the 50 that you examined, as I understand it, 10 of those are in what you would call moderately risky condition and 13 of them are in serious—negative cashflows, all that sort of thing, interest past due, unable to service their debt.

Now those two categories, Mr. Gillum, come to $306 million and represent almost 50 percent of the 50 you looked at. Is that correct? 23 of the 50 are either in moderate or serious condition?

Mr. **Gillum**. Yes, sir.

The **Chairman**. Excuse me, go ahead.

Mr. **Gillum**. But we want to be careful that we focus on what this tells us at this moment, and what I think we can generalize on at the moment is, that we need to look at the way valuation is being handled—the process, if you will. And we are going to make some changes internally in the way we look at the way valuation is being done.

I do not want to go that one further step and conclude from the data we have that that means all of those companies are in trouble or that there is some kind of a real serious problem throughout the industry. I do not think we can conclude that from the data we have at hand.

What it says is, we think there is need to improve the valuation process and the way that it is being done. And I think the numbers and the data tells us that clearly enough.

The **Chairman**. First of all, how did you go about determining whether or not the valuation of each SBIC's portfolios, how did you go about determining whether its valuation was valid or not?

Mr. **Gillum**. We have not said precisely that their valuation is wrong. What we have looked for through this process are indicators, such as those that we found in River Capital.

To precisely say that the portfolio of companies are not properly valued would take extensive field work, and we would have to be out there onsite doing appraisals and all kinds of other things that we have not done to date.

The **Chairman** Well, do you not think, given the nature and the magnitude of the problem, that we would be justified in asking SBA, for example, to either hire independent auditors to get this done in a hurry or take some dramatic action?

Now, here we have one company that you have described as in severe condition. And my question is, for example, how was that company overlooked, based on the audit that they submitted to SBA?

Mr. **Gillum**. Well, I think that question has basically been answered in a number of forms in previous testimony. I think the Burton Report demonstrates that there is a need for increased vigilance and monitoring within the program. And I think that basically leads back to the question of how things get missed.

Whether or not we should launch a major effort to go out there, I am just reluctant to suggest that, Mr. Chairman. I think currently we have a number of efforts under way, that may eventually try to answer that question for you. I certainly do not have the resources, and I do not know if the Agency has the resources, to go out with an across-the-board study.

I can only operate within the resources that I have and, frankly, those are starting to hemorrhage at the moment.

The **Chairman**. Mr. Gillum, I do not believe you have the personnel to do this quickly. And I think, as I say, I think the problem is severe enough that draconian measures are needed. And I am not at all sure that we ought not to hire some outside help, some outside auditing firms, to go in and do not just one of those audits that we get on an annual basis, but actually go in and tell us what the condition of these things are.

I mean, when you audit 50 of the biggest SBICs we have, each of which owes the SBA over $5 million, and you come back and tell us that 23 of the 50 are in moderate to severe financial difficulty, that really throws up a red flag to me. It makes me wonder about the other 350. Does it not to you?

Mr. **Gillum**. Well, I want to keep going back to the fact that we have not done an audit; that there are indicators of problems from looking at the data from this study. I do not want to take that extra step of jumping to the conclusion that they are severely financially impaired. We need to look at that a little bit more. And I think we are going to find out more about that from the second study.

The **Chairman**. Nobody would be more pleased than I would be if we did this extensive audit on all of these SBICs and we found that this was a false alarm, that they are in much better shape than we thought. But I do not want to sit here as Chairman of this Committee and preside over the demise of this thing. I mean, it is like getting nibbled to death by a duck; almost every other day there is a new one.

And that is exactly what—there is this analogy with the S&L. We had people coming in and saying, no, everything is just hunky-dory. Now, you are not saying that, to your credit. You are saying that this raises a concern. And I am saying that, based on S&L experience, we need to be out there auditing every one of these people and finding out as quickly as we can and try to preserve the assets that the taxpayers of the country might be able to get from some of these outfits that are obviously headed south.

Mr. **Gillum**. Well, I hope I do not appear to be arguing with you, because I am not.

The **Chairman**. No, no, I understand.

Mr. **Gillum**. I just would like——

The **Chairman**. You say, first of all, you do not have the personnel to do it.

Mr. **Gillum**. No. And I would like to have some time, I would like to buy some time, to see what we learn from our initial study. We can step back from it and analyze the results a little more, get input from the second study that we are doing, and have an opportunity to use the contractor that the Agency is acquiring to do onsite valuation work.

And that is what you were talking about, getting a contractor available that we could send to an SBIC, and that contractor would value the assets of that SBIC.

The **Chairman**. How much time are you talking about, Mr. Gillum?

Mr. **Gillum**. Well, I would hope that in 60 days, 90 days, to have some initial——

The **Chairman**. Well, that does not seem unreasonable. But what I want are the kinds of assurances that I think we are all entitled to, and that is, what are we going to get out of this 60-day wait? Are we going to find out exactly where we are on this? That is what I want to know.

I want to know how many of these outfits, how many of these companies, are in severe or moderate or serious or however you want to classify them, I want to know what their condition is, so that we can take such action as we deem appropriate based on legitimate, valid information.

Mr. **Gillum**. I cannot precisely tell you that we will have that answer, although that is our hope. I think within the next 60 days, 90 days, what we would be able to tell you is that we have answers to those kinds of questions; that we have perfected the methodology and the kind of programs that will get us to the answers; or that we cannot do it and that your suggestion is the only one left. That is, do an across-the-board kind of down-and-dirty evaluation of assets. It would be very expensive, Mr. Chairman.

The **Chairman**. Well, it may be very expensive, but in the long run, we might save money by doing that.

Mr. GILLUM. We might. And that may, ultimately, be the only answer. I just would like to try within the next 60 to 90 days, in incremental steps, to do more analysis, and work with the program officials to focus on answering that kind of fundamental question for you.

The CHAIRMAN. We have got a total exposure here, from these 23 of the 50 you audited, of $306 million. And to repeat, that is not beanbag.

Mr. GILLUM. No, sir.

The CHAIRMAN. And even if the figure is $200 million, that is still a lot of money, and it jeopardizes this program. I like the program. I do not want to throw the baby out with the bath water. I want to see this program continued, if at all possible. But I can tell you that we have already learned enough here to know that this is a very, very serious matter, and that this program is in some jeopardy.

What rights does SBA have, for example, when they determine, as you have now determined—on page 5 of your testimony you say, "One SBIC with SBA leverage of $5.4 million has severe financial problems. The licensee's July 1989 financial report to SBA showed that 55 percent of its loans were delinquent and that it had a negative cashflow. Our onsite review found that 49 percent of the loans were delinquent for more than 90 days, and that the licensee had to borrow money from shareholders to meet expenses.

"The licensee did not have formal portfolio valuation procedures. Our review indicated that a substantial number of the investments are overvalued."

In addition, an independent auditor's compilation dated as of January 31, 1990, that is a short 5 months ago, stated the licensee was delinquent on senior debt of $3.5 million and "conditions exist which raise substantial doubt about the company's ability to continue is a growing concern."

Does SBA have the right to put them under receivership right now?

Mr. GILLUM. Yes, sir, I believe they do.

The CHAIRMAN. Why have they not done it? I mean, when this report came in in January, and this company was found to be in this kind of condition, my question is, why were they not—I mean, it seems to me that this company is a hopeless situation. We are not naming them here; I do not know who they are. But I can tell you, this company hasn't a prayer, unless they find an unbelievable sugar daddy.

And my question is, why has SBA not put them under receivership to try to preserve whatever assets they have left?

Mr. GILLUM. I cannot precisely tell you why. I can tell you a number of the things that they are dealing with in those kinds of situations. One, of course, is to place the company in liquidation. The other is to balance that out against programmatic objectives and give consideration to the fact that there could conceivably be portfilio companies that could be placed in jeopardy, if the SBIC itself is placed in liquidation.

I know they are trying to balance out those kinds of things. I just cannot tell you precisely in this case why.

The CHAIRMAN. Well, that is not your call. You are the IG. That is not your decision to make. You are supposed to furnish this information to somebody over there, and they are supposed to make that decision.

Mr. GILLUM. Well, we will. And, of course, that is the problem with this kind of data, it is preliminary. We are in the middle of the study, and we rushed this together to respond to the Committee's needs. I finished this statement about 5 last night, and we rushed it up to meet our deadlines. The Agency, in all fairness, is getting it just as fresh as we are out of the machine.

So they need some time to respond and I am sure they will.

The CHAIRMAN. Well, Mr. Gillum, let me say that I appreciate the rapidity with which you have responded to my request. But my request goes right to the heart of the reasons of these hearings. We want to find out what is the status of the rest of them? We know how many are in liquidation. We know what happened to Royal, River Capital, Clinton, and all the rest of them. And we want to know how many more potential cases like that we have.

Now what you are saying is you have done a survey that admittedly is not an indepth study of each one of these 50 companies. But you have enough information to tell us that in your opinion 23 of the 50 are in difficulty of some degree or another.

Mr. GILLUM. There are indicators of problems there in terms of valuation. Now we want to go back and look at those. The whole thrust of the study was to determine whether or not we had valuation problems as revealed by the River Capital situation. Clearly, I think even the preliminary results of what we have to date tell us that that is the case.

Now, the next step in this is how do we, within resource availability, focus on those companies where they have these indicators and determine if the indicators are valid. In one of these cases, where we had indicators of problems, we and field tested and the indicators were not substantiated.

So we need some more time to finish this work and do more analysis. I will be the first to tell you, if anybody wants to place resources or money on the table to acquire assets and/or auditors or people to go out and do the work, that we are prepared to cooperate and do whatever we are supposed to do statutorily to carry out that function.

The CHAIRMAN. Well, Mr. Gillum, I can tell you that based on what I know right now, I may go after that money in the appropriations process, which is coming up in 30 to 60 days from now. Because to sit here and do nothing, in light of what I consider to be an impending crisis—if we did not learn anything else in the S&L problem, we certainly should have learned that we could have saved ourselves billions of dollars by shutting a lot of these things down a lot sooner than we did.

They continued to lose money; they continued to operate at a loss, which has compounded our problems. Of course, I will say in that case, the Administration was up here telling us everything is just hunky-dory. Somebody suggested the other day, we should have put lie detectors on them while they were testifying. And they sort of lulled Congress into believing that everything was fine and that they were going to work their way out of it. The problem maybe was—I can remember at one time one of them testified, he thought we had a $10 billion problem, and everybody gasped for breath. They thought that was terrible.

We now know that the problem is somewhere between $150 billion and $500 billion. And while as I say this is not on the same scale, we certainly should have learned some things from that. Do you not agree?

Mr. GILLUM. Yes, sir.

The CHAIRMAN. Do you not think we ought to get a fairly in-depth audit made of these organizations as quickly as we can and find out where we are? Which ones need to be put into receivership? A lot of them are going under. Would you agree with me on that?

Mr. GILLUM. Certainly the ones that are in the 4 and 5 category are ones that are in high risk, and that would seem to be what that tells us.

The CHAIRMAN. Well, do we not preserve assets by shutting them down at the earliest possible time? Most of the time? There may be rare exceptions to that. But most of the time, do you not save the taxpayers' money by putting those people under receivership and liquidation and trying to preserve those assets?

Mr. GILLUM. If there is a situation where assets are being dissipated that would clearly be the case. I still go back to the notion that those people that are running the program have to very carefully look at each one of those situations to make sure that we are not damaging portfolio companies and to try to further the program as a whole.

Simply put, yes, when you know it is going under, and you want to preserve the Government's interest, then quick and timely action is always the best. There is no question about it.

The CHAIRMAN. Mr. Gillum, the GAO is going to testify later this morning that the American Institute of CPAs' audit guide for investment companies is severely flawed and needs to be revised. And he is going to also say that that institute has no plans for doing so.

Now, do you know of anything that SBA could do to encourage that profession to take steps to update and revise its guidance to practitioners? We now know that these audits, especially in the case of River Capital, did not raise the kind of alarms that it should have. And in my opinion, based on that, if these audit procedures are not going to give us any more information than that one did, then it is just a scam to go through with it; it is just sort of a charade.

Mr. GILLUM. Well, there are a number of things that can be done, short of forcing the AICPA to move and change their rules. One of those I testified to earlier, and that is a revised guide for the CPAs doing review work of SBICs.

We can prescribe in many ways what the CPAs do out there, even if the AICPA will not change its rules, and that is what we have done, in a draft audit guide, to move in that direction.

The second part of that is setting up a quality assurance program within our own office to look at the work being done, to make sure it is done correctly.

Getting the AICPA to change a rule might be helpful, but I think we would be putting our eggs in one basket by trying to influence an outside body, ruling body, that has its own constituency and bureaucracies to deal with. I would much rather deal with those things that we can do ourselves. And that would be to get our own guide up to date, tighten it up, put requirements in the form of our own guidance out to the CPAs and have them do it.

The CHAIRMAN. What would you—I want to nail this down, and I want the record to be clear on it. You say you want another 60 to 90 days. And I want to know precisely what you are going to do in that 60 to 90 days and how is that going to help this Committee make up its mind about what we ought to do about this whole thing.

Mr. GILLUM. Well, precisely, in that 60 to 90 days, we are going to try to get a handle on whether or not we can answer the question for you of the condition of the industry, if you will.

The CHAIRMAN. What do you propose to do to do that?

Mr. GILLUM. Well, within our——

The CHAIRMAN. What are you going to do in addition to what you just got through doing now with these 50 SBICs?

Mr. GILLUM. OK. With those 50 we have about 18 or so of those that have not been field tested. And we will be looking to see if there is some way that we can go out and look at them to test our indicators on those. We also are starting to——

The CHAIRMAN. When you say test your indicator, what do you mean by that?

Mr. GILLUM. Well, the indicators are arrived at by questions that we pose to ourselves as we go through the files and the work that has been done by the CPA firms. For example, one of the things in River Capital was where was the interest going? And so we ask ourselves that question as we look through the files in the Investment Division, which include the annual financial reports, and the CPA report, and that sort of thing.

We look to see if the same kinds of things occurring at River Capital are occurring with the company that we are looking at. If there are, then we say that is a flag, an indicator of a problem.

Now in the field test part, we want to go out and test to see if our indicators are validated. Or are there other considerations that would otherwise say that company is OK? And that is what we are trying to do.

We also have in place, and have initiated this week, a second study, due to interest expressed by the Administrator, to do a similar kind of review of those SBICs that have already been rated as 4 and 5 or high risk. We will subject them to the same kind of file review and if there are indicators of valuation problems, we will field test those.

We also have on hand, and it should be available to us in this process, a contract that the Agency is setting up with the firm which would allow us—if we can perfect the methodology—to engage that company to have them value the assets of that SBIC. It may include any number of things to test what the assets of those portfolio companies are really worth.

As we do that, then, I think we are going to have a better handle on making an assessment, short of doing them all, as to what the conditions may be out there. But it is going to rely on testing and trying to narrow down the focus each time, so that we can do it in a timely manner and within personnel and cost constraints.

The **CHAIRMAN**. Now, Mr. Gillum, these 23 out of the 50, the Government's exposure on those is $306 million. What is our total exposure on the 50 that you studied?

Mr. **MCCLINTOCK**. It is $575 million.

The **CHAIRMAN**. $575 million?

Mr. **MCCLINTOCK**. Yes, sir.

The **CHAIRMAN**. All right, now we have an exposure of slightly over one-half of a billion dollars on the ones that are in liquidation, too; do we not?

Mr. **MCCLINTOCK**. Yes.

The **CHAIRMAN**. And what is our exposure on the remaining roughly 350 MSBICs and SBICs?

Mr. **MCCLINTOCK**. About $625 million.

The **CHAIRMAN**. So the total exposure in this program is about $1.6 billion or $1.7 billion? Is that right?

Mr. **MCCLINTOCK**. That is correct.

The **CHAIRMAN**. Now, Pete, if here in the case of 23 out of 50, we have 46 percent of them in serious to moderate difficulty, out of the $575 million exposure, we have over 50 percent of the dollars in jeopardy of the 50 you studied; and these are the 50 biggest ones. And we do not know what kind of shape the other 350 are in, do we?

Mr. **MCCLINTOCK**. No, although probably about 110 of the 350 have no SBA leverage, so there is no financial risk there.

The **CHAIRMAN**. So we have no exposure in those?

Mr. **MCCLINTOCK**. No, we do not.

The **CHAIRMAN**. You can forget about them so far as I am concerned. I am not interested in those that do not owe the SBA any money.

Mr. **MCCLINTOCK**. And there are many that have very low levels of leverage. There are some that—there are a couple that have less than $500,000. There are quite a few—we could supply the number for the record—that have only a $.5 million of leverage.

The **CHAIRMAN**. How quickly could you supply the Committee with a list of everyone of the SBICs and our exposure?

Mr. **MCCLINTOCK**. We could supply it fairly quickly. I do not know if we have an up-to-date list as of today, but we could supply something fairly quickly.

The **CHAIRMAN**. I would like to get that, if you will, you or whoever is running that program over there. I would like to see the list and the total exposure that the Government has on each one.

[Material follows:]

Small Business Investment Companies
Active on June 24, 1990

SBIC name	State	Private Capital	SBA Leverage
1st Source Capital Corporation	IN	2,500,000	0
767 Limited Partnership	NY	1,515,152	1,500,000
A.T. Capital Corp.	OH	9,824,630	0
AB SBIC, Inc.	CT	1,000,000	1,000,000
AMF Financial, Inc.	CA	626,000	0
ANB Venture Corporation	IL	10,000,000	0
ASEA-Harvest Partners II	NY	1,016,559	1,000,000
Advent Atlantic Capital Company, LP	MA	4,956,680	6,000,000
Advent IV Capital Company	MA	12,050,000	3,000,000
Advent Industrial Capital Company, LP	MA	3,326,400	7,000,000
Advent V Capital Company LP	MA	29,075,000	29,000,000
Alaska Business Investment Corp.	AK	2,500,000	0
Albuquerque SBIC	NM	552,000	1,500,000
All State Venture Capital Corporation	CT	1,000,000	0
Alliance Business Investment Company	OK	3,480,502	3,860,000
Allied Investment Corporation	DC	6,784,708	24,350,000
Alpha Capital Venture Partners, L.P.	IL	4,867,307	0
American Commercial Capital Corporation	NY	1,000,000	3,000,000
American Security Capital Corp., Inc.	DC	2,500,000	1,500,000
Amev Capital Corp.	NY	5,500,000	5,000,000
Argentum Capital Partners, LP	NY	3,000,000	0
Atalanta Investment Company, Inc.	NY	5,422,321	11,800,000
Atlas II Capital Corporation	MA	1,000,000	1,000,000
BDP Capital Ltd.	DE	1,000,000	0
BNP Venture Capital Corporation	CA	1,550,000	0
BNY One Capital Corp.	NY	16,400,000	0
BT Capital Corp.	NY	85,008,034	25,500,000
Banc One Venture Corp.	WI	6,000,000	2,000,000
BancBoston Ventures, Incorporated	MA	75,000,000	0
Bancorp Hawaii SBIC	HI	2,000,000	500,000
Bancorp Venture Capital, Inc.	CA	2,250,000	2,250,000
Bando McGlocklin Capital Corporation	WI	7,175,113	21,520,000
BankAmerica Ventures, Inc.	CA	22,500,000	0
Bankers Capital Corp.	MO	632,000	1,010,000
Bever Capital Corp.	MA	1,000,000	2,000,000
Bishop Capital II, LP	NJ	1,262,626	0
Bishop Capital, L.P.	NJ	3,000,000	1,000,000
Boston Hambro Capital Company	MA	5,942,914	2,000,000
Bridger Capital Corp.	NY	2,505,000	5,000,000
Brittany Capital Company	TX	1,000,000	3,200,000
Business Achievement Corporation	MA	550,000	1,610,000
Business Capital Corp.	TX	510,000	800,000
Business Ventures, Incorporated	IL	564,750	600,000
CFB Venture Capital Corporation	CA	1,000,000	0
CMNY Capital II, L.P.	NY	4,000,000	0
CMNY Capital L.P.	NY	5,400,000	21,100,000
Capital Impact Corp.	CT	7,216,171	9,000,000
Capital Investments, Inc.	WI	4,806,833	7,580,000
Capital Marketing Corporation	TX	11,155,106	32,460,000
Capital Resource Corporation	WA	1,087,373	1,000,000
Capital Resource Co. of Connecticut	CT	976,365	2,855,000

SBIC name	State	Private Capital	SBA Leverage
Capital Southwest Venture Corp.	TX	5,794,784	16,000,000
Capital for Business, Inc.	MO	6,000,000	0
Capital for Terrebonne, Inc.	LA	750,000	480,000
Central Texas SBI Corporation	TX	600,000	0
Charleston Capital Corporation	SC	1,012,409	1,000,000
Charter Venture Group, Incorporated	TX	1,325,000	1,000,000
Chase Manhattan Capital Corporation	NY	50,000,105	0
Chemical Venture Capital Associates	NY	68,914,772	0
Chestnut Capital International II LP	MA	6,729,124	12,500,000
Chestnut Street Partners, Inc.	MA	4,000,000	5,000,000
Circle Ventures, Inc.	IN	1,000,000	500,000
Citicorp Investments Inc.	NY	9,500,000	0
Citicorp Venture Capital, Ltd.	NY	127,197,602	10,000,000
City Ventures, Inc.	CA	2,000,000	0
Clarion Capital Corp.	OH	8,919,409	7,540,000
Continental Illinois Venture Corp.	IL	25,200,450	0
Creditanstalt Capital Corporation	NY	1,000,000	0
Crestar Capital, LP	VA	9,100,000	7,500,000
Crosspoint Investment Corporation	CA	667,500	600,000
Croyden Capital Corp.	NY	1,457,963	1,000,000
DC Bancorp Venture Capital Company	DC	1,500,000	2,000,000
Developers Equity Capital Corporation	CA	677,000	1,010,000
Dewey Investment Corp.	CT	510,650	0
Diamond Capital Corp.	NY	2,087,500	4,000,000
Domestic Capital Corp.	RI	500,000	1,000,000
Dominion Capital Markets Corporation	VA	3,009,451	0
Draper Associates, a California LP	CA	2,015,000	6,000,000
ESLO Capital Corp.	NJ	688,323	1,500,000
Edwards Capital Company	NY	7,200,000	21,450,000
Energy Assets, Inc.	TX	1,593,109	500,000
Enterprise Capital Corporation	TX	5,000,000	12,000,000
Enterprise Venture Cap Corp of Pennsylvania	PA	1,147,649	0
Erie SBIC	PA	1,080,000	1,000,000
FBS SBIC, Limited Partnership	MN	10,951,559	0
FCA Investment Company	TX	1,017,000	240,000
Fairway Capital Corp.	RI	2,500,000	0
Ferranti High Technology, Inc.	NY	3,000,000	1,000,000
Fidelcor Capital Corporation	PA	5,100,000	0
Fifty-Third Street Ventures, L.P.	NY	6,173,207	7,960,000
Financial Opportunities, Inc.	KY	900,000	2,700,000
Financial Resources, Incorporated	TN	1,000,320	0
First Capital Corp. of Chicago	IL	91,771,742	3,600,000
First City, Texas Ventures, Inc.	TX	2,000,000	0
First Connecticut SBIC	CT	10,691,160	27,950,000
First Interstate Capital, Inc.	CA	15,000,000	0
First Interstate Equity Corp.	AZ	1,000,000	0
First Interstate Cap. Corp. of Texas	TX	19,057,008	19,000,000
First Maryland Capital, Inc.	MD	616,600	0
First New England Capital, LP	CT	5,067,500	3,500,000
First Ohio Capital Corporation	OH	2,500,000	1,300,000
First Princeton Capital Corporation	NJ	1,252,048	2,250,000
First SBIC of Alabama	AL	2,166,700	6,500,000
First SBIC of California	CA	25,000,000	0
First United SBIC, Inc.	MA	600,000	0

SBIC name	State	Private Capital	SBA Leverage
First Valley Capital Corporation	PA	1,010,000	0
First Wall Street SBIC, LP	NY	3,050,000	4,000,000
First of Nebraska Investment Corp.	NE	1,000,000	0
Fleet Venture Resources, Inc.	RI	10,207,604	1,500,000
Floco Investment Company, Inc. (The)	SC	491,900	0
Florida Capital Venture, Ltd.	FL	3,013,040	0
Ford Capital, Ltd.	TX	8,045,500	0
Franklin Corporation SBIC (The)	NY	10,003,114	3,640,000
Fundex Capital Corp.	NY	2,101,000	6,150,000
G C & H Partners	CA	1,323,281	887,505
GHW Capital Corp.	NY	1,000,000	0
Genesee Funding, Inc.	NY	1,000,000	0
Gold Coast Capital Corporation	FL	680,000	1,930,092
Greater Washington Investments, Inc.	MD	8,485,655	4,000,000
Gries Investment Company	OH	682,961	1,432,400
Hamco Capital Corp.	CA	4,710,404	11,000,000
Hanover Capital Corp. (The)	NY	1,000,001	1,875,000
Heller Equity Capital Corporation	IL	12,000,000	0
Heritage Capital Corp.	NC	2,050,265	3,500,114
Hickory Venture Capital Corporation	AL	9,000,000	0
Houston Partners, SBIP	TX	1,656,447	2,200,000
Imperial Ventures, Inc.	CA	3,001,781	0
Interstate Capital Company, Inc.	NY	1,250,000	3,500,000
Investor's Equity, Inc.	GA	3,083,700	0
J & D Capital Corp.	FL	1,000,106	2,050,000
Jiffy Lube Capital Corporation	MD	2,000,000	1,200,000
Jupiter Partners	CA	3,253,720	4,500,000
Kansas Venture Capital, Inc.	KS	3,740,690	0
Kitty Hawk Capital, Limited Partnership	NC	1,905,000	3,000,000
Kwiat Capital Corp.	NY	510,000	500,000
LRF Capital, Limited Partnership	MA	1,000,000	0
Lowcountry Investment Corporation	SC	1,908,950	1,620,000
M & I Ventures Corp.	WI	7,448,370	0
M & T Capital Corp.	NY	5,007,486	0
MBI Venture Capital Investors, Inc.	MO	5,750,000	0
MH Capital Investors, Inc.	NY	20,000,000	0
MNC Ventures, Inc.	MD	1,000,000	0
MVenture Corp	TX	16,250,000	35,000,000
Maine Capital Corp.	ME	1,000,000	500,000
Mapleleaf Capital Ltd.	TX	3,000,002	5,000,000
Marcon Capital Corp.	CT	826,550	2,400,000
Mariner Venture Capital Corporation	FL	1,000,000	0
Market Capital Corp.	FL	786,000	1,800,000
Marwit Capital Corp.	CA	1,176,926	1,000,000
Meridian Capital Corp.	PA	3,000,000	0
Meridian Venture Partners	PA	5,000,000	0
Merrill Pickard Anderson & Eyre I	CA	28,083,735	0
Metropolitan Capital Corporation	VA	2,238,418	3,090,000
Metropolitan Venture Company, Inc.	CA	1,000,000	1,000,000
Mezzanine Capital Corporation	MA	30,000,000	25,000,000
Midland Capital Corp.	MO	1,000,000	0
Milk Street Partners, Inc.	MA	1,000,000	0
Monarch-Narragansett Ventures, Inc.	MA	10,000,000	18,970,000
Moneta Capital Corp.	RI	2,002,500	6,000,000

SBIC name	State	Private Capital	SBA Leverage
Monmouth Capital Corp.	NJ	2,083,247	3,670,000
MorAmerica Capital Corporation	IA	5,000,000	10,650,440
Morgan Investment Corporation	DE	30,000,000	0
Mountain Ventures, Inc.	KY	1,640,000	0
NCNB SBIC Corporation	NC	2,500,000	0
NCNB Texas Venture Group, Incorporated	TX	36,000,044	9,000,000
NCNB Venture Company, L.P.	NC	20,176,039	0
NYBDC Capital Corp.	NY	500,000	770,000
NYSTRS/NV Capital, Limited Partnership	NY	8,250,730	0
NatWest USA Capital Corporation	NY	20,000,000	0
National City Capital Corporation	OH	5,001,291	4,530,000
Neptune Capital Corporation	TX	1,062,707	0
New England Capital Corporation	MA	20,000,000	0
New West Partners II	CA	1,003,123	1,000,000
Norstar Capital Inc.	NY	3,932,425	0
North Riverside Capital Corporation	GA	3,010,500	7,500,000
Northeast SBI Corp.	MA	378,802	1,130,000
Northeastern Capital Corporation	CT	1,000,951	2,120,000
Northern Pacific Capital Corporation	OR	1,111,464	1,500,000
Northland Capital Venture Partnership	MN	773,822	800,000
Northwest Venture Partners	MN	50,446,962	0
Norwest Equity Partners IV	MN	5,000,000	0
Norwest Growth Fund, Inc.	MN	16,350,000	18,504,000
Norwood Venture Corp.	NY	5,000,000	9,000,000
Old Stone Capital Corporation	RI	6,991,500	4,270,000
Omega Capital Corporation	TX	530,000	500,000
Onondaga Venture Capital Fund, Inc.	NY	2,502,500	0
Orange Nassau Capital Corporation	MA	2,000,000	1,000,000
PBC Venture Capital Inc.	CA	550,000	0
PNC Capital Corp.	PA	5,044,971	0
Paribas Principal Incorporated	NY	3,000,000	0
Pioneer Ventures Limited Partnership	MA	5,157,122	1,200,000
Polaris Capital Corp.	WI	2,114,759	0
Preferential Capital Corporation	NY	509,380	1,000,000
Premier Venture Capital Corporation	LA	4,260,639	0
Pyramid Ventures, Inc.	NY	14,997,499	0
Quantum Capital Partners, Ltd.	FL	1,500,000	4,000,000
Queneska Capital Corporation	VT	1,500,000	0
Questech Capital Corp.	NY	5,000,000	12,000,000
R & R Financial Corp.	NY	505,000	200,000
RFE Capital Partners, L.P.	CT	10,107,679	13,000,000
Rand SBIC, Inc.	NY	1,605,000	1,600,000
Realty Growth Capital Corporation	NY	1,000,000	1,200,000
Reedy River Ventures	SC	3,182,300	3,200,000
Revelation Resources, Ltd.	TX	1,123,605	0
Richmond Square Capital Corporation	RI	3,025,000	0
Ritter Partners	CA	3,228,802	4,500,000
Rocky Mountain Equity Corporation	AZ	600,000	500,000
Rust Capital Limited	TX	7,000,000	12,000,000
SBI Capital Corp.	TX	2,250,000	2,700,000
SBIC of Connecticut Inc. (The)	CT	617,160	1,000,000
SLK Capital Corp.	NY	1,000,000	0
San Antonio Venture Group, Inc.	TX	1,051,000	500,000
San Joaquin Capital Corporation	CA	1,086,971	3,235,000

SBIC name	State	Private Capital	SBA Leverage
SeaGate Venture Management, Inc.	OH	1,010,000	1,000,000
Seafirst Capital Corporation	WA	3,000,000	5,500,000
Seaport Ventures, Inc.	CA	1,355,452	2,000,000
Shared Ventures, Inc.	MN	752,000	1,200,000
Shawmut National Capital Corporation	MA	6,000,000	0
Sigma Capital Corp.	FL	1,000,000	0
Small Bus. Electronics Investment Corp.	NY	600,000	0
Small Business Inv. Capital, Inc.	AR	1,150,000	2,750,000
Society Venture Capital Corporation	OH	5,700,000	0
South Texas SBIC	TX	1,500,000	1,000,000
Southern Berkshire Investment Corp.	MA	1,000,000	0
Southern Tier Capital Corporation	NY	350,111	800,000
Southern Ventures, Inc	AR	1,387,500	0
Sovran Funding Corp.	VA	14,000,000	3,000,000
Sterling Commercial Capital, Inc.	NY	4,863,750	8,000,000
Stevens Capital Corporation	MA	506,000	0
Sundance Venture Partners, L.P.	CA	2,500,000	0
Sunwestern Capital, Ltd.	TX	2,357,472	5,500,000
Sunwestern Ventures, Ltd.	TX	10,293,029	25,500,000
Super Market Investors, Inc.	WI	500,000	750,000
TLC Funding Corp.	NY	1,250,000	2,940,000
Tamco Investors (SBIC) Incorporated	OH	350,000	1,050,000
Tappan Zee Capital Corporation	NJ	750,000	2,250,000
Texas Commerce Investment Company	TX	8,700,000	0
Tidewater SBI Corp.	VA	1,000,000	500,000
U.S. Bancorp Capital Corporation	OR	1,730,000	0
UBD Capital, Inc.	CO	2,000,000	0
UNCO Ventures, Inc.	TX	3,000,000	0
UST Capital Corp.	MA	1,752,800	2,000,000
Unicorn Ventures II, L.P.	NJ	4,553,000	4,000,000
Unicorn Ventures, Ltd.	NJ	2,508,513	6,000,000
Union Venture Corp.	CA	23,550,000	0
United Financial Resources Corp.	NE	500,000	500,000
United Mercantile Capital Corp.	NM	629,888	1,200,000
United Missouri Capital Corporation	MO	2,500,000	0
VK Capital Company	CA	1,050,505	500,000
Vadus Capital Corp.	MA	2,000,000	1,500,000
Valley National Investors, Inc.	AZ	15,000,000	0
Vega Capital Corp.	NY	2,402,861	6,190,000
WFG-Harvest Partners, Ltd.	NY	3,026,412	0
Wallace Capital Corporation	RI	2,015,000	750,000
Walnut Capital Corp.	IL	5,123,800	10,000,000
Washington Trust Equity Corp.	WA	705,000	0
Washington Ventures, Inc.	DC	2,200,000	3,250,000
Wells Fargo Capital Corporation	CA	2,000,000	0
Wesbanc Ventures, Ltd.	TX	2,530,000	1,500,000
Westamco Investment Company	CA	800,000	0
Western Financial Capital Corporation	TX	5,546,744	10,640,000
Wilbur Venture Capital Corp.	AZ	1,000,000	0
Winfield Capital Corp.	NY	1,100,000	3,750,000
Wisconsin Community Capital, Inc.	WI	1,005,000	0
Wood River Capital Corporation	NY	15,512,000	26,000,000
Number of SBICs--265		1,713,147,125	870,619,551

301(d) Small Business Investment Companies
Active on June 24, 1990

301(d) SBIC name	State	Private Capital	SBA Leverage
ABC Capital Corp.	CA	1,000,000	3,000,000
Alabama Capital Corporation	AL	1,550,000	4,650,000
Alabama Small Business Investment Company	AL	1,005,000	0
Alliance Enterprise Corporation	PA	3,030,200	2,700,000
Allied Business Investors, Inc.	CA	600,000	1,200,000
Allied Financial Corporation	DC	7,000,000	12,000,000
Ally Finance Corp.	CA	600,000	950,000
American Asian Capital Corporation	NY	503,000	500,000
Amoco Venture Capital Company	IL	3,676,750	6,153,000
Argonauts MESBIC Corporation (The)	MA	1,000,000	1,000,000
Asian American Capital Corporation	CA	638,200	1,000,000
Associated Southwest Investors, Inc.	NM	717,000	1,700,000
Astar Capital Corp.	CA	1,020,000	4,080,000
Avdon Capital Corp.	NY	1,000,000	2,500,000
Bentley Capital	CA	1,500,000	2,980,000
Best Finance Corporation	CA	1,001,200	2,000,000
Broadcast Capital, Inc.	DC	3,050,000	5,800,000
Business Assistance Center-MESBIC, Inc.	FL	1,100,000	0
Business Equity and Development Corp.	CA	1,877,532	1,000,000
CVC Capital Corp.	NY	3,495,000	6,000,000
Cactus Capital Company	OH	1,080,000	0
Calista Business Investment Corp.	AK	750,000	750,000
Calsafe Capital Corp.	CA	1,000,000	0
Capital Circulation Corporation	NJ	1,000,000	2,000,000
Capital Dimensions Ventures Fund, Inc.	MN	7,342,662	10,000,000
Capital Investors & Management Corp.	NY	900,000	1,500,000
Capital Management Services, Inc.	AR	1,406,310	2,500,000
Center City MESBIC, Inc.	OH	500,000	500,000
Charterway Investment Corporation	CA	1,597,336	3,000,000
Chen's Financial Group, Inc.	TX	1,000,000	3,000,000
Chicago Community Ventures, Inc.	IL	1,005,000	2,005,000
Chickasaw Capital Corporation	TN	500,000	500,000
Colorado Invesco, Inc.	CO	1,020,600	560,000
Combined Fund, Inc. (The)	IL	1,100,250	1,629,000
Concord Finance Corp.	NY	1,000,000	0
Consumers United Capital Corporation	DC	2,608,000	0
Continental Investors, Inc.	CA	2,000,000	5,000,000
Dearborn Capital Corp.	MI	2,280,364	1,000,000
East Coast Venture Capital, Inc.	NY	1,000,000	2,000,000
East West United Investment Company	VA	500,000	1,500,000
Elk Associates Funding Corporation	NY	5,487,808	8,785,000
Equal Opportunity Finance, Inc.	KY	1,988,535	1,600,000
Equico Capital Corp.	NY	10,550,000	10,295,000
Equitable Capital Corporation	CA	642,995	1,505,000
Esquire Capital Corp.	NY	1,266,200	0
Evergreen Capital Company, Inc.	TX	1,851,000	4,000,000
Everlast Capital Corporation	NY	2,856,673	5,400,000
Exim Capital Corp.	NY	660,000	1,800,000
Fair Capital Corp.	NY	625,000	500,000
Far East Capital Corp.	CA	1,000,000	0
First American Capital Funding, Inc.	CA	823,250	3,292,500

301(d) SBIC name	State	Private Capital	SBA Leverage
First American Lending Corporation (The)	FL	500,000	800,000
First Growth Capital, Inc.	GA	1,025,000	0
Formosa Capital Corp.	NJ	1,000,000	2,000,000
Freshstart Venture Capital Corporation	NY	1,807,978	3,810,000
Fulcrum Venture Capital Corporation	DC	2,000,000	2,000,000
Future Value Ventures, Incorporated	WI	1,020,000	1,000,000
Greater Phila. Venture Capital Corp., Inc.	PA	760,981	1,505,000
Hanam Capital Corp.	NY	1,302,000	0
Helio Capital, Inc.	CA	1,000,000	2,000,000
Hop Chung Capital Investors, Inc.	NY	510,000	1,000,000
Ibero American Investors Corp.	NY	1,246,471	1,897,000
Ideal Financial Corporation	FL	500,000	1,000,000
Intercontinental Capital Funding Corp	NY	500,000	1,750,000
International Paper Cap. Formation, Inc.	TN	1,000,000	1,000,000
Japanese American Capital Corporation	NJ	525,000	1,490,000
Jardine Capital Corp.	NY	1,000,000	2,000,000
LaiLai Capital Corp.	CA	1,000,000	700,000
MESBIC Financial Corp. of Dallas	TX	3,825,332	3,050,000
MESBIC Financial Corp. of Houston	TX	1,619,200	854,000
Magna Pacific Investments	CA	1,000,000	1,080,000
Manhattan Central Capital Corp.	NY	1,000,000	1,000,000
Medallion Funding Corporation	NY	9,234,000	21,734,000
Metro-Detroit Investment Company	MI	2,000,000	6,000,000
Milestone Growth Fund, Inc.	MN	1,300,000	0
Minority Broadcast Investment Corp.	DC	1,000,100	1,500,100
Minority Enterprise Funding, Inc.	TX	1,310,000	2,650,000
Minority Equity Cap. Company, Inc.	NY	2,615,747	3,504,046
Monsey Capital Corp.	NY	1,257,040	3,000,000
Motor Enterprises, Inc.	MI	1,500,000	2,000,000
Mutual Investment Company, Inc.	MI	2,293,815	5,808,000
Myriad Capital, Inc.	CA	1,334,530	5,338,120
Neighborhood Fund, Inc. (The)	IL	730,000	950,000
New England MESBIC, Inc.	MA	500,000	1,500,000
New Kukje Investment Company	CA	1,020,000	3,000,000
New Oasis Capital Corporation	NY	500,000	1,500,000
North America Inv. Corporation	PR	1,075,000	2,250,000
North American Funding Corporation	NY	750,000	1,500,000
Opportunity Capital Corporation	CA	2,526,043	2,180,500
Pacific Venture Capital, Ltd.	HI	1,000,000	700,000
Pan Pac Capital Corp.	NY	503,000	1,505,000
Peterson Finance and Investment Company	IL	1,035,000	1,520,000
Pierre Funding Corp.	NY	2,762,074	7,111,800
Positive Enterprises, Inc.	CA	505,000	505,000
Power Ventures, Inc.	AR	500,000	1,000,000
Pro-Med Investment Corporation	TX	5,000,000	3,000,000
RSC Financial Corp.	CA	526,508	1,900,000
Renaissance Capital Corporation	GA	1,000,000	0
Rubber City Capital Corporation	OH	1,000,000	0
Rutgers Minority Investment Company	NJ	1,499,000	905,000
SCDF Investment Corp.	LA	2,700,010	3,119,549
Salween Financial Services, Inc.	PA	800,000	725,000
San Joaquin Business Investment Group Inc	CA	1,000,000	0
Security Financial and Investment Corp.	MD	510,000	500,000
Situation Ventures Corporation	NY	1,000,200	3,000,000

301(d) SBIC name	State	Private Capital	SBA Leverage
South Bay Capital Corporation	CA	1,017,577	0
Southern Orient Capital Corporation	TX	550,000	1,650,000
Sowa Capital Corp.	CA	1,000,000	0
Square Deal Venture Capital Corp.	NY	546,000	1,200,000
Sun-Delta Capital Access Center, Inc.	MS	1,258,100	0
Syncom Capital Corp.	DC	2,250,000	6,125,000
Tennessee Equity Capital Corporation	TN	1,337,000	1,670,000
Tennessee Venture Capital Corporation	TN	500,000	500,000
Tower Ventures, Inc.	IL	2,000,000	3,000,000
Transpac Capital Corporation	NJ	1,000,000	2,000,000
Transportation Capital Corp.	NY	6,561,380	10,148,333
Triad Capital Corp. of New York	NY	545,253	500,000
Trico Venture, Inc.	NY	1,000,000	1,700,000
Trusty Capital Inc.	NY	1,000,000	0
Tuskegee Capital Corporation	AL	850,000	0
United Capital Investment Corp.	NY	1,030,000	3,000,000
United Oriental Capital Corporation	TX	1,000,000	3,700,000
Valley Capital Corp.	TN	1,145,000	600,000
Venture Group, Inc.	FL	500,000	500,000
Venture Opportunities Corporation	NY	875,000	2,300,000
Vinh An Capital Investment, Inc.	CA	1,050,000	0
Washington Finance and Investment Corp.	VA	1,005,000	3,000,000
Watchung Capital Corp.	NY	500,000	1,000,000
West Tennessee Venture Capital Corporation	TN	1,250,000	0
Western General Capital Corporation	CA	1,000,000	0
Yang Capital Corp.	NY	500,000	1,500,000
Yusa Capital Corp.	NY	1,035,000	2,000,000
Zaitech Capital Corporation	NJ	1,000,000	1,000,000
Zenia Capital Corp.	NY	1,000,000	0
Number of SBICs--134		203,440,204	300,769,948

The CHAIRMAN. So what you are saying, I guess, Pete, and, Mr. Gillum—I guess you would back this up is—the problem is not—now, we still have out of those 150, though, we have still got close to a $600 million exposure, right?

Mr. MCCLINTOCK. Yes.

The CHAIRMAN. Well, that is close to an average, if you count those that do not have any leverage, of the remaining 200 if we have got 600, that is an average of $3 million each on those. And while that is relatively small, it is not anything like the exposure we have on some of the bigger ones, I think those are worth looking at too.

Mr. MCCLINTOCK. Well, actually, it would be less. I may have misspoken. In the 4 and 5 risk categories, there is some financing involved in those. That would have to be backed out to come up with your average. But it would be in the several million dollar range.

The CHAIRMAN. It is really hard for me to keep my support up for a program where we are about to lose half of all the money we have ever loaned, or at least half the money we have loaned right now.

Mr. MCCLINTOCK. Well, again, it is——

The CHAIRMAN. And the program has been a good one. We all know that it has had some eminent successes. And when I first came on this Committee, I thought it was a great idea, because venture capital is the biggest problem small business has, here is a chance—here is a place where they could get it, when nobody else would give it to them.

Mr. MCCLINTOCK. Just to clarify for the record, we do not necessarily lose all the money once it goes into liquidation.

The CHAIRMAN. No, I understand that. And that ought to be made clear, that our exposure and our potential loss is not the same thing. I keep coming back to River Capital, where they were identical.

Yes.

Mr. GILLUM. I think there is a lot of things on the table for concern. I have been concerned for the 3 years that I have been at SBA—and I have said it over and over, and I know it sounds like a broken record—in terms of the way we approach examining these operations, and I think you hit on it a moment ago, Mr. Chairman, when you pointed out there is 110 of them, and we should not be wasting our time, a lot of time, with those. That has been one of the historical problems—we have done that.

I think we have a lot of reasons for concern. I think the Committee has focused a lot of attention on the problems here, and I think it has been healthy. I think what we still have though is a high level of concern. I do not know that we know, with any certainty, that those companies, even those rated 4 and 5, are in imminent danger of going out of business or being placed in liquidation tomorrow. That may be the case, but I do not think we know that.

The CHAIRMAN. Well, I keep coming back to this point, Mr. Gillum, I want to know.

Mr. GILLUM. I know.

The CHAIRMAN. I want to know. Should they be put in receivership? Or should be given some longer time? And I want the data that we use to decide whether they go into receivership and liquidation or not. I want it to be hard data, good information. And if they are allowed to continue operating, it has to be with a reasonable degree, a reasonable expectation that they are going to make it.

You know, this S&L thing has got everybody around there antsy. We just—we do not want any more, and we are not going to have any more. Certainly we are not going to have any more here, if I can prevent it from happening.

Now one other question, I have asked the SBA to declare a moratorium on issuing new SBIC charters. Do you know whether or not they have done that?

Mr. GILLUM. No, I do not, sir.

The CHAIRMAN. That is just an informal request, that is not a legislative mandate. But I think until we know where we are, that is a legitimate thing. But you do not know the answer?

Mr. GILLUM. No, sir.

The CHAIRMAN. Senator Burns, do you have any questions?

STATEMENT OF HON. CONRAD BURNS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator BURNS. Not specifically. And, Mr. Chairman, I am sorry I am late this morning. We had a little thing called the Missouri River that is going dry. Does that affect you?

The CHAIRMAN. No, but we will be happy to fill it up for you from the Arkansas. [Laughter.]

Senator BURNS. We are really interested if you can get that water to run up hill. I mean, I understand that some of you have that power.

The CHAIRMAN. I told Lloyd Bentsen the other day that Texans—the first delegation that ever called on me when I was elected Governor was from Texas. And they want to buy Arkansas water, and we have steadfastly resisted that. I think Senator Pryor ran for reelection on; do not give Texas our water. And I told Lloyd the other day, come get all he wants. [Laughter.]

Senator BURNS. This morning we had a briefing from Director Engeleiter. And we are sure we have problems in this, and it is just like the point made that, even though we have some at risk here, there is going to be some recovered that is not all in our exposure; it is just the cash money that we have right now. But whenever we liquidate, we get some of that back.

We also want to make that clear for the S&Ls, too, and nobody likes this S&L thing. I think that was the toughest vote that I cast in this body, because I come from a State where the S&Ls, they rank fourth in the Nation as far as soundness and liquidity is concerned. And we went through the same agriculture and the same energy crisis that any other part of the country did.

And so for the most part, I think, we have been, if I have any criticism at all—and I think it is one that has been probably expressed by Senator Bumpers and very ably so—that we are just slow on these audits and slow to act. We know we have been around the money business. You know, your first loss is the cheapest one you will have. And also that, you know, when you look at the rate of recovery or the rate of loans that go bad, especially, from an agency that is the agency of last resort when it comes to borrowing money, it is very good. It is very good.

So that is not to say though that we cannot be better. And for the most part, I think, you are doing—but I think the criticism that I would have, that we just do not act fast enough whenever those red flags go up. Let us stick our spurs in that D-ring and take a deep seat and get it done. And those are my concerns.

Thank you, Mr. Chairman. I have no specific questions at all. Thank you.

The **CHAIRMAN**. Thank you very much, Senator Burns. You have said it well.

Mr. Gillum, I will check with—just check an informal poll among other Committee Members and tell them the gist of this, this morning; we will make a decision. We will probably send you a formal request that you perform this further audit over the next 60 to 90 days. Because I just do not think, frankly, I do not think I have much alternative. I do not think I can get the money to do these crash audits, in-depth audits. I mean, I do not think I can get it done much faster than you could do this anyway. I may go after that money, but I could not get it in less than 60 days; meanwhile, you could be doing this.

Mr. **GILLUM**. Exactly.

The **CHAIRMAN**. So it would be foolish in the extreme for me not to suggest that you go ahead and do that, but I would like to send you a formal written request to do that.

Mr. **GILLUM**. Well, we will do that. The Administrator has already expressed an interest in it, and we are pursuing it. The answer may ultimately be in 60 to 90 days that we cannot answer your question, and there may be no other alternative but to go with the broader study and bring in some outside resources. I would like to say, if you get us the money, and we will see that it is wisely used to carry out this——

The **CHAIRMAN**. When I talk about the money, Mr. Gillum, I am not specifically getting the money for the IG's office. And the reason I say this is because you would have a tough time hiring enough auditors to do this, even if you had the money very quickly. And I think some of the auditing firms, some of the bigger auditing firms could get at it in a hurry and get it done much faster. And that is not to insult your Agency or anything. I just think you would have a hard time hiring enough competent auditors to get this done. Do you want to respond to that?

Mr. **GILLUM**. I was not planning to; just saying, if you make the money available, and you want the study done, we can contract out to get the work done.

The **CHAIRMAN**. OK. We will keep the record open for 3 or 4 days for additional questions in writing.

Thank you very much for coming over.

Mr. **GILLUM**. Thank you, sir.

The **CHAIRMAN**. Our next witness is Brian—is it Crowl- ey or Crow-ley?

Mr. **CROWLEY**. Crowl-ey.

The **CHAIRMAN**. Crowley. Director of Planning and Reporting from GAO. Mr. Crowley, welcome to the Committee. We are very pleased to have you and look forward to hearing your testimony.

STATEMENT OF BRIAN P. CROWLEY, DIRECTOR OF PLANNING AND REPORTING, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY DAVID CLARK, ASSOCIATE DIRECTOR, FINANCIAL MANAGEMENT SYSTEMS AND AUDIT OVERSIGHT, GAO

Mr. **Crowley**. Thank you, Mr. Chairman.

To my immediate right is Dave Clark. He is our Associate Director who handles all of our audits dealing with audit quality.

Mr. Chairman, I have a 10-page statement that I will briefly go through. I will skip around in it, if you do not mind.

The **Chairman**. That is fine.

Mr. **Crowley**. But, I would hope like to submit it for the record in total.

Mr. Chairman, you asked us about 3 weeks ago to look into several questions concerning audits of River Capital Corp.—particularly, those done by Arthur Andersen & Co.—primarily, because you were concerned about the failure of that company, and the fact that SBA is going to possibly lose $28.5 million.

In performing our work, we looked at the work papers of Arthur Andersen; we talked to Arthur Andersen officials about the work that was done. We talked to the examiner appointed by the Bankruptcy Court. And we also talked to Mr. Gillum about a number of areas. As agreed with your staff, we primarily concentrated our work on the valuation area—the valuation of the assets.

Let me briefly go through the five questions that you raised. When I get to the latter ones, I will give some more detail. But the first one was whether there was any impropriety in the Inspector General's staff sharing a draft audit report for River Capital with Arthur Andersen prior to its finalization.

Mr. Chairman, that draft audit report was one which criticized Arthur Andersen. And as such, even under our own standards, we require that any criticisms that are going to show up in a draft or final audit report be shown to the person or the entity that has been criticized ahead of time. So we do not think that that was improper at all.

You asked about possible improprieties in how the office of the IG handled the River Capital case, including the lack of a final report on the failure of River Capital. The company was in bankruptcy and there existed the possibility of litigation between the Agency and the accounting firm. We looked into this a while ago.

At that time we found that no improprieties existed in the handling of the case. Our standards, the Generally Accepted Government Auditing Standards [GAGAS], require that written audit reports be prepared communicating the results of each Government audit and that these audits be issued promptly, so as to make the information available for timely use by management.

Now, the IG conducted his examination in July 1988, and, although it had not completed its work, management of SBA was fully aware of the serious problems at River Capital. The company had defaulted on its scheduled loan payments. In August 1988, SBA's Investment Division transferred the River Capital account to the Office of Portfolio Management, which was responsible for recovering the $28.5 million claim against River Capital. As a result of this transfer, River Capital could receive no additional SBA funding.

In November 1988, the Assistant IG for Audit reviewed the draft OIG report on River Capital and instructed the auditor to revise it, in part, to provide more detailed support for the auditor's conclusion. We took a look at that draft report, and we agree with the Assistant IG's conclusion on the need for changes.

In February the Assistant IG sent the revised draft to SBA management and Arthur Andersen for review and comment. Then he and his staff spent the next months further revising the draft. The task was made difficult by changes in personnel, including the retirement of the auditor who conducted the audit and initially drafted the report. River Capital filed for bankruptcy in August 1989. And in October 1989, the SBA General Counsel and Assistant IG asked the Inspector General not to issue the final report to avoid any potential impact on possible future litigation against River Capital officials and Arthur Andersen.

Based on our review of the draft report and discussions with OIG officials and in light of the requests from those responsible for possible litigation, we did not believe the IG engaged in any impropriety by not issuing a final report.

The third question relates to whether Arthur Andersen followed generally accepted auditing standards in the performance of its 1986 and 1987 audits of River Capital. Mr. Chairman, I am not going to directly answer that question for two reasons. One is that SBA is considering possible litigation against Arthur Andersen, and I would like to avoid any possible impact on that litigation. And the second is that, when we make a judgment about whether an accounting firm follows auditing standards, we consider that to be a very serious judgment.

I can tell you this, in the S&L crisis, we looked at some audits of some failed S&Ls. We looked at a cross-section of audits. We just did not look at one. We tried to get a sense for what was the practice in the industry before we finally came up with a decision as to whether auditing standards were or were not violated.

So in this case, Mr. Chairman, I would like not to directly answer that question. But I would like to go on to some other things which I think you were primarily interested in—what can be done to improve the auditing and what is being done.

Let me give you a little flavor as to the types of things that are out there now. We have generally accepted auditing standards. We also have guides or interpretations of those standards. Now, those guides or interpretations do not have the authority of the standards, but the auditors and others rely heavily on them for specialized accounting and auditing practices within particular industries.

In this particular industry the audit guide is called Audits of Investment Companies. That guide contains the following with regard to the issue of investment valuation. Let me just read you this quote:

> The independent auditor does not act as an appraiser for security values estimated in good faith by the board of directors——

The CHAIRMAN. I am sorry, I did not get that. Say that again.

Mr. CROWLEY.

> The independent auditor does not act as an appraiser ——

The **Chairman**. I see. I have it in front of me now. Go ahead.

Mr. **Crowley** [continuing].

> For security values estimated in good faith by the board of directors, and is not expected to substitute his or her judgment for that of the fund's directors. Instead, the auditor should review the company's procedures for its continuing appraisal of such securities, determine whether the methods established for valuation are followed and make certain that these methods have been reviewed and approved currently by the board of directors. The auditor should review the procedures applied by the directors in valuing such securities, and inspect the underlying documentation to determine whether the procedures are reasonable and the documentation appropriate for that purpose.

The valuation of investments was critical to the fair presentation of River Capital's financial statements because investments represented about 85 percent of its assets. Based on our review of the work papers, it appears that Arthur Andersen took steps that were designed to carry out the guidance contained in the audit guide with regard to the valuation of securities.

The partner and manager assigned to the audit attended the board meetings at which companies in River Capital's portfolio were discussed and year-end valuations for financial statement purposes were determined. The information provided the Arthur Andersen officials for the meeting included investment overview, investment strategy and other financial information for the companies in River Capital's portfolio. The work papers also contained notes made during the board's annual meeting on the valuation of the companies in the portfolio.

Let me skip over to the next page, Mr. Chairman, and tell you that Arthur Andersen pretty much spelled out in its work papers and its final report what it did. It qualified its report. Its opinion letter stated that,

> The investment values were estimated by the board of directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the directors in arriving at their estimate of value of such securities and investments and have inspected underlying documentation, and in the circumstances, believe procedures are reasonable and the documentation appropriate.
>
> However, because of the inherent uncertainty of valuation, the board of directors' estimate of values may differ significantly from the values that would have been used had a ready market existed for the securities; and the differences could be material.

Arthur Andersen also qualified its report with regard to the collectibility of the interest receivable contained in the financial statements.

Let me now go on to the fourth question, Mr. Chairman, because that deals with the use of generally accepted auditing standards. And we do have problems with the interpretation of the guide concerning the valuation of the investments by SBIC companies.

As mentioned earlier, the auditors rely heavily on these guides when planning and conducting their audit tests. However, while we agree with the Investment Company Audit Guide statement that auditors do not act as appraisers, we believe that the guidance does not go far enough in detailing the types of documentation and records that auditors should examine when auditing portfolio valuations determined by boards of directors.

In our view, the audit guide wording offers the opportunity to conduct less than a sufficient investigation. The guide should require that the auditors look behind the financial and summary business outlook information discussed during the annual board of directors valuation meeting. For example, auditors should compare planned business activities and forecasts with reported results and seek out information on similar companies in the same industry for comparison purposes.

When problems are indicated, auditors should consider visiting some of the companies and examining financial and other information in addition to the data provided during the board's meeting. Also, they should consider contacting Government officials whose decisions may have a material impact on a portfolio company's ability to continue operations or achieve its planned level of activity.

We believe that the audit guide should be revised by the profession after sufficient study and deliberation. However, when we talked to the chairman of the AICPA's investment companies committee, he told us that they do not have any current plans for revising the audit guide.

Let me briefly summarize my response to question 5—what we think needs to be done. No. 1, as I just said, we think the guide needs to be revised, to put more onus on the auditor for the valuation of the assets and to be more specific on what the auditor needs to do to satisfy him or her as to the reasonableness of the valuations.

SBA needs to do some things, too. We think that SBA should require that these audits be done in accordance with, the Generally Accepted Government Auditing Standards [GAGAS]. These standards require two reports in addition to an opinion report. They require a compliance report and a report on internal controls. GAGAS explicitly requires an auditor to test for compliance with laws and regulations and to evaluate the system of internal controls. The auditor is encouraged to test for fraud, and such tests can show overinflated asset values.

Another thing, we think the IG, as he said today, needs to stay on top of these kinds of audits. He needs to do desk reviews of the audits when they are brought in, and he needs to do quality assessment reviews of the audits that have actually been conducted. That is when he can actually take a look at the work papers of the auditor conducting these audits. He needs to provide timely written guidance to the CPAs in the performance of these audits. He needs to ensure that these reports are submitted in a timely manner.

Mr. Chairman, in terms of urgency, SBA and the IG can do these things now. It may take the AICPA a little time to deliberate how to change the guide, but SBA and the IG do not have to wait.

Mr. Chairman, that pretty much summarizes my statement. We will be ready to answer any questions you might have.

[The prepared statement of Mr. Crowley follows:]

United States General Accounting Office
GAO Testimony

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Audits of Small Business Investment Companies

Statement of
Brian P. Crowley
Director of Planning and Reporting
Accounting and Financial Management Division

Before the
Committee on Small Business
U.S. Senate

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss certified public accounting firm audits of small business investment companies (SBICs). In particular, you asked that we address several questions concerning audits of River Capital Corporation, an SBIC that owed the Small Business Administration (SBA) $28.5 million when it filed for bankruptcy in August 1989.

In performing our work, we reviewed the working papers for the final River Capital audit conducted by the public accounting firm of Arthur Andersen and discussed the audit with officials from this organization. Further, we discussed the River Capital case with the examiner appointed by the Bankruptcy Court, the SBA inspector general, and officials from SBA's Investment Division. As agreed with the committee, we focused our work on the investment valuation area.

The following responses to your questions reflect the results of this work.

1. Was there any impropriety in the inspector general's staff sharing a copy of the draft audit report for River Capital with Arthur Andersen prior to its finalization?

Offices of Inspectors General (OIGs) are required, by the Inspector General Act of 1978, to perform their audits in accordance with generally accepted government auditing standards. These standards state that one of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible auditee officials and others as may be appropriate. In the River Capital case, the OIG's draft audit report questioned Arthur Andersen's adherence to generally accepted auditing standards during the company's audit of River Capital. Because the draft report was critical of the auditing firm, we believe that there was no impropriety in the OIG giving Arthur Andersen an opportunity to review and comment on the draft report.

2. Was there any impropriety in how the office of inspector general handled the River Capital case, including the lack of a final report on the failure of River Capital, considering that the company was in bankruptcy and that there existed the possibility of litigation between the agency and the accounting firm?

As the result of an allegation received late last year, we examined the OIG's handling of the River Capital case and found that no improprieties existed in its handling of the case. We considered several points in arriving at this conclusion.

Generally accepted government auditing standards state that written audit reports are to be prepared communicating the results of each government audit and that these reports are to be issued promptly so as to make the information available for timely use by management.

The OIG conducted its examination of River Capital during July 1988. Although it had not yet received the OIG audit report, SBA management was aware of serious problems at River Capital. The company had defaulted on its scheduled loan payments to the Small Business Administration and, in August 1988, SBA's Investment Division transferred River Capital to the Office of Portfolio Management. This office was responsible for recovering SBA's $28.5 million claim against River Capital. As a result of this transfer, River Capital could receive no additional SBA funding.

In November 1988, the Assistant Inspector General for Audit reviewed the draft OIG audit report on River Capital and instructed the auditor to revise it, in part, to provide more detailed support for the auditor's conclusions. We reviewed the November draft report and agree with the Assistant Inspector General's conclusion on the need for changes.

In February 1989, the Assistant Inspector General sent the revised draft to SBA management and Arthur Andersen for review and comment. He and his staff spent the next months revising the draft. This task was made more difficult by changes in personnel, including the retirement of the OIG auditor who conducted the audit and initially drafted the report.

River Capital filed for bankruptcy on August 24, 1989. In October 1989, the SBA General Counsel and the Assistant U.S. Attorney asked the inspector general not to issue the final audit report to avoid any potential impact on possible future litigation against River Capital officials and Arthur Andersen.

Based on our review of the draft report and discussions with OIG officials, and in light of the requests from those responsible for litigation involving the River Capital case, we do not believe the inspector general engaged in any impropriety by not issuing a final audit report.

3. Did Arthur Andersen follow generally accepted auditing standards in the performance of its 1986 and 1987 audits of River Capital?

When conducting audits, certified public accounting firms must conduct their work in accordance with generally accepted auditing standards. In addition to these standards, the American Institute of Certified Public Accountants (AICPA) issues interpretations and audit guides on the application of standards. These interpretations and guides do not have the authority of standards, but auditors and others rely heavily on them for specialized accounting and auditing practices within particular industries. The applicable AICPA guide for audits of companies participating in SBA's Small Business Investment Company (SBIC) program is Audits of Investment Companies. The guide contains the following with regard to the issue of investment valuation.

> "The independent auditor does not act as an appraiser for security values estimated in good faith by the board of directors, and is not expected to substitute his or her judgment for that of the fund's directors. Instead, the auditor should review the company's procedures for its continuing appraisal of such securities, determine whether the methods established for valuation are followed, and make certain that these methods have been reviewed and approved currently by the board of directors. The auditor should review the procedures applied by the directors in valuing such securities, and inspect the underlying documentation to determine whether the procedures are reasonable and the documentation appropriate for that purpose."

The valuation of investments was critical to the fair presentation of River Capital's financial statements because investments represented 85 percent of its assets. Based on our review of Arthur Andersen's working papers, it appears that Arthur Andersen took steps that were designed to carry out the guidance contained in the audit guide with respect to the valuation of securities. The partner and manager assigned to the audit attended the board of directors meeting at which the companies in River Capital's portfolio were discussed and year-end valuations for financial statement purposes were determined. The information provided the Arthur Andersen officials for the meeting included investment overview, investment strategy, and other financial information for the companies in River Capital's portfolio. The working papers also contained the audit manager's notes made during the board's annual meeting on the valuation of companies in the portfolio.

Although not fully documented in the working papers, Arthur Andersen representatives informed us that the audit staff evaluated the procedures used by the board during the valuation meeting and considered them adequate.

In addition, the working papers showed that the audit staff performed a number of other steps related to the investment account. For example, they confirmed equity and debt holdings and interest receivable from companies in which River Capital invested, physically observed securities and compared the results with company records, and tested changes in investment account balances.

Finally, Arthur Andersen qualified its audit report based on uncertainties concerning the investment and interest receivable balances contained in River Capital's financial statements. The report, which is in accordance with the AICPA's audit guide, stated that the investment values

> "were estimated by the board of directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the directors in arriving at their estimate of value of such securities and investments and have inspected underlying documentation, and in the circumstances, believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the board of directors' estimate of values may differ significantly from the values that would have been used had a ready market existed for the securities, and the differences could be material."

Arthur Andersen also qualified its report with regard to the collectibility of the interest receivable contained in the financial statements.

4. Would the use of generally accepted auditing standards in the River Capital audit by Arthur Andersen have revealed the

overvaluations of investments or other problems which led to River Capital's failure?

The River Capital audits by the OIG and Arthur Andersen were conducted prior to River Capital's bankruptcy and, as such, their working papers and other records did not specifically identify the reasons for its failure. Our work did, however, raise some questions about the adequacy of generally accepted auditing standards, as interpreted by the AICPA's audit guide, concerning the valuation of investments by SBIC companies.

Generally accepted auditing standards require that the auditor gather sufficient competent evidential matter as a basis for formulating an opinion on the financial statements. Therefore, their use should identify excessive overvaluations of investments recorded on a company's financial statements.

As mentioned earlier, auditors rely heavily on the AICPA's audit guide when planning and conducting their audit tests. However, while we agree with the investment company audit guide's statement that auditors do not act as appraisers, we believe that the guidance does not go far enough in detailing the types of documentation and records that auditors should examine when auditing portfolio valuations determined by boards of directors. In our view, the audit guide wording offers the opportunity to conduct less than a sufficient investigation. The guide should require that the auditors look behind the financial and summary business outlook information discussed during the annual board of directors valuation meeting.

For example, auditors should compare planned business activities and forecasts with reported results and seek out information on similar companies in the same industry for comparison purposes. When problems are indicated, auditors should consider visiting some of the companies and examining financial and other information in addition to the data provided during the board's meeting. In addition, they should consider contacting government officials whose decisions may have a material impact on a portfolio company's ability to continue operations or achieve its planned level of activity.

We believe that the audit guide should be revised by the profession after sufficient study and deliberation. We have contacted the Chairman of the AICPA's Investment Companies Committee who stated that no plans currently exist for revising the audit guide.

5. Could or should other changes be made in either the Inspector General's audit procedures or the Investment Division's review of SBIC audits which might help determine whether other licensees may be in jeopardy in spite of good reports from the public accounting firms which are performing annual audits?

We have not had the opportunity to perform the detailed analyses of the SBIC policies and procedures and inspector general examination work needed to fully respond to this question. However, in a May 1988 report, CPA AUDIT QUALITY: Improved Controls Are Needed to Ensure Quality Audits of Federal Loan Programs (GAO/AFMD-88-3), we made several recommendations to improve controls for relying on the work of certified public accountants (CPAs). These recommendations included agency reviews of the quality of CPA reports and a requirement that CPAs follow generally accepted government auditing standards when conducting their audits.

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Mr. Chairman, that concludes my formal statement. I will be happy to answer any questions you or members of the Committee may have.

The **Chairman**. Mr. Crowley, let me just ask you about the last statement that you made. Are you saying that the IG in these annual audits ought to require the auditing company to meet these standards, even though the accounting procedures do not require it? Are you saying that the IG ought to implement these suggestions you have just made now?

Mr. **Crowley**. Yes, sir, yes.

The **Chairman**. And not wait?

Mr. **Crowley**. That is right.

The **Chairman**. I mean, obviously, these changes by the American Institute is going to take a long time to get done probably.

Mr. **Crowley**. The AICPA changing its guides will add credibility and acceptance throughout the accounting industry to the standards. But the IG can require what he wants. He can require—or SBA can require—that the IG's guidelines be followed in the conduct of these audits. So he can specify what he thinks needs to be done.

The **Chairman**. That is an excellent suggestion.

On page 5, where you have set out, the applicable American Institute of CPA's guide for audits of companies participating in SBA's Small Business Investment Company Program is Audits of Investment Companies.

Mr. **Crowley**. Yes.

The **Chairman**. And the guide contains the following with regard to the issue of investment valuation. Now that goes right to the heart of the problem we are talking about here because, just in the case of River Capital, for example, 85 percent of their assets were in their portfolios. And I suspect that is probably a decent figure for all of the SBICs. I would say that probably 75 percent to 100 percent of all their assets are in their investments, in their investment portfolios.

So the thing that troubled me about Arthur Andersen in this particular case was—and quite frankly, the last sentence of their sort of exculpatory language here, you know, that is what we call cover your rear around here—the last sentence says, "However, because of the inherent uncertainty of valuation, the board of director's estimate of values may differ significantly from the values that would have been used had a ready market existed for the securities, and the differences could be material."

To me, that is sort of like saying that, you know, do not pay any attention to these valuations because they do not really mean anything.

Mr. **Crowley**. That is right.

The **Chairman**. And that is what we have got to correct in the IG's office and do it right away. Now, I am not, you know, there may be a lawsuit between the SBA and Arthur Andersen, and I am not going to comment on that, because I am not as concerned—that is done. And I am not concerned about that.

What I am concerned about are how these valuations—I still, I must say, I do not know how you could reach a valuation by sitting around listening to a bunch of board members talk about valuations that the auditor says, so far as they are concerned, were made in good faith.

Mr. CROWLEY. Well, the guide puts the whole responsibility for determining valuations on the back of the board of directors. And that is as it should be, quite frankly. But it also should be that the accountant or the auditor needs to go in and do more to ensure that those valuations are good valuations. We agree with you on that.

The CHAIRMAN. That is where our problem is here.

Mr. CROWLEY. You know, there are a number of things that can be done. You are dealing with some firms that are not in the best state financially. So you are going to have some investments where you know that there are going to be losses. What you really need to do is to make these firms come up with business plans, predict what they want to do.

Are you going to go through losses for 3 years and then get better? Then on top of that, have them report each year on the progress that they are making with regard to those plans, and have the auditor look at that. How are you coming with regard to your plans? Are we going to end up with nothing at the end of 5 years? Or are you going along the path that you predicted that you would go?

Some of these outfits are very, very risky to start with. That is why we have the program.

The CHAIRMAN. In the case of River Capital, Mr. Crowley, I do not know whether you had occasion or any need to look at this or not, but one stock, I believe in the roughly 40 stocks in their portfolio, one stock was selling on the open market at 2 cents a share. And it was valued at close to $1 million in the audit; and at 2 cents a share, it was worth less than $75,000. Is that correct, John?

Mr. CROWLEY. That sounds correct, yes. Mr. Clark will address that one.

The CHAIRMAN. How could you excuse that, when you have got something that is on the market and has a market valuation?

Mr. CLARK. Mr. Chairman, the reference to the 2 cents on the share relates to the 1986 audit that Arthur Andersen did of River Capital. We focused our work on the 1987 audit. We do know that at the time of the 1986 audit, Arthur Andersen did have available to it information that showed that it was trading at 2 cents. Management had presented that information to the board of directors during the board of director's valuation meeting and that River Capital was valuing it at 27 cents on the share.

However, for the 1987 audit the circumstances changed and I have here the information that management presented to the board when the board was making its valuation decision. This information showed that the latest over the counter quote, in December 1987, was much higher. It was quoted at 35 cents for sell and 27 cents for a buy, with the average cost to the company being close to 13 cents a share.

The CHAIRMAN. I am not questioning the information, but nobody ever presented that before. So this stock went from 2 cents a share in 1986 to 35 cents a share in 1987?

Mr. CLARK. According to management. This is a representation by management to the board. One of the things that we are talking about here by way of our testimony——

The CHAIRMAN. But was that in fact correct?

Mr. **Clark**. And that is exactly what we are talking about. We would like to see the audit guide and the procedures out there require the auditor to go behind that and, in fact, verify it. If I am looking at the 1987——

The **Chairman**. What do they value it—did Arthur Andersen do this audit in 1986?

Mr. **Clark**. Yes, they did.

The **Chairman**. What did they value that stock at then?

Mr. **Clark**. I do not know the specific answer to that. Management's cost of the stock in 1986 was 27 cents, in 1986.

The **Chairman**. That was management's cost of the stock?

Mr. **Clark**. Right.

The **Chairman**. And it was selling at 2 cents a share on the market?

Mr. **Clark**. Right.

Mr. **Crowley**. Well, remember, this is an over-the-counter market. And we do not know——

The **Chairman**. Pardon?

Mr. **Crowley**. This is an over-the-counter market, is it not?

Mr. **Clark**. Yes.

The **Chairman**. Yes. I understand that. But I mean, you know, you can call a broker any time you want and find out what a certain stock would cost you on over-the-counter markets.

Mr. **Clark**. To the extent that you have that information. For a lot of these small business concerns, that information is not available.

The **Chairman**. Is it not?

Mr. **Crowley**. It is not.

The **Chairman**. Well, I do not have any other questions of you. I found this—just a moment, I want to be sure.

Did you determine that Arthur Andersen on the River Capital case, for example, had reviewed the procedures applied by the directors in valuing their securities? Here in the guide for auditing investment companies, the last sentence says,

> The auditor should review the procedures applied by the directors in valuing such securities and inspect the underlying documentation to determine whether the procedures are reasonable and the documentation appropriate for that purpose.

Did you look at that to determine whether or not Arthur Andersen had done that?

Mr. **Crowley**. Arthur——

Mr. **Clark**. We know that Arthur Andersen attended the board meeting where the board set the valuations. And we know that Arthur Andersen observed that process. Arthur Andersen informed us and reported in its audit report that it did that. Arthur Andersen informed us and reported in its audit report that it felt the procedures were adequate.

We know that Arthur Andersen did look at the documentation provided by management to the board for the board to make its decisions. And in Arthur Andersen's work papers there is evidence that they were performing some analysis of management's information for the board. So to that extent, we believe they did that as set out by the audit guide.

The **Chairman**. Senator Lieberman.

STATEMENT OF HON. JOSEPH I. LIEBERMAN, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator **Lieberman**. Mr. Chairman, I have no questions. I have a statement that I would like to have included in the record. And just to congratulate you on your persistence here and to say that the more we know the more trouble this really good program, a program with a good purpose, seems to be in. And the more clear it seems that there was not really an adequate system to warn us of these troubles.

Every group sort of says it is the other group's responsibility. Then when you pursue it, then, there is no there there, you know. There is no real audit going on at those critical moments. And I appreciate the work that you have done and the suggestions that you make, some of which I think are excellent. And, again, I would just like to state for the record that I strongly support the call by the Chairman, that SBA stop licensing new SBICs until this program can be properly assessed and brought under control.

Thank you, Mr. Chairman.

[The prepared statements of Senators Lieberman, Boschwitz, and Dixon follow:]

STATEMENT OF
SENATOR JOSEPH I. LIEBERMAN

SENATE COMMITTEE ON SMALL BUSINESS
HEARING ON SMALL BUSINESS INVESTMENT COMPANIES

Thursday, June 20, 1990

Mr. Chairman, Thank you for calling this third hearing on the health of the Small Business Investment Company industry with particular focus on two recent and quite costly failures, River Capital Corporation and Royal Business Funds Corporation.

I have spoken before on the critical role Small Business Investment Companies can play, particularly in light of a recent tightening of credit for small firms. I believe that S.B.I.C.'s, with their financial and technical expertise, offer small businesses the opportunity for venture or seed capital they would otherwise have no ability to secure individually or through conventional lending institutions. When successful, S.B.I.C.'s bring high risk products and services to the market at a relatively low risk and cost to the government or the economy.

Unfortunately, the results of the committee's two prior hearings, and reports from the Inspector General suggest that something in the program has gone seriously wrong. We are now facing a situation where 170 S.B.I.C.'s have failed and represent a potential exposure for the government and the taxpayers in excess of $500 million. In early May, we heard Inspector General Charles Gillum testify that of the 404 S.B.I.C.'s presently in operation, 19% represent an above average risk, and 14 are presently being investigated by the Justice Department.

Perhaps, even more troubling, was that Mr. Gillum and his colleagues were unable to gauge for us the overall health of the program. Their only industry-wide information was based on independent audit reports. Mr. Gillum testified that, in the case of River Capital Corporation, the deficiencies in their accounting practices were "not appropriately identified and reported upon by the firm that performed River Capital's annual financial audit".

Mr. Chairman, on May 16, we heard testimony from Mr. Charles Hertzberg, the Acting Associate Administrator for Finance and Investment. As I understand it, Mr. Hertzberg is the gentleman with overall responsibility for the program.

He stated that: "In summary, approximately 15 percent of the SBIC's (57 in number) with aggregate leverage of $180,032,500 were in unsatisfactory financial condition while 85 percent were in acceptable to strong financial condition". But, as you know Mr. Chairman, this assessment did not include the 170 that have already been placed in liquidation. If we take those into account, we are really looking at almost 30 percent of the SBIC's bankrupt with an additional 10 percent in trouble--totaling a potential 40 percent failure rate for the program which is far more serious than the 15 percent Mr. Hertzberg made reference to. I, for one, am conerned about the glossy finish that was placed on a pretty gloomy situation.

Mr. Chairman, both the Inspector General and the Associate Administrator have testified that the only industry-wide information on the health of S.B.I.C.'s is based on the reviews of independent audit firms, such as Arthur Anderson & Co. who will testify here today. But in reviewing Mr. Jenkins' written testimony, it seems that Arthur Anderson's role in assessing the financial strength of a given S.B.I.C. is very limited at best. He states that:

> "the S.B.A.'s own regulations, place responsibility for valuation decisions solely with the board of directors [of the company] and note that the auditor is not to act as an appraiser, substituting its judgement for that of the directors with respect to the fair value of investments"

Mr. Chairman, if this is the case, we have now completed the circle, and nobody -- the I.G., the S.B.A. or the Independent Auditors -- have taken responsibility or been able to report to us the present health of this program. We are not even getting finger pointing, we are getting absolutely nothing. It sort of reminds me of the story where "none of the snowflakes would take responsibility for the avalanche".

As I have listened to the testimony and reviewed the audit reports these past few weeks, I could not help but conclude that there are serious shortcomings in S.B.A.'s oversight of existing program participants and the liquidation of failed ventures. The cases of both Royal and River Capital clearly illustrate these shortcomings. Therefore, Mr. Chairman, I fully support your recommendation that S.B.A. stop licensing new S.B.I.C.'s until this program can be properly assessed and brought under control.

Again, Mr. Chairman, thank you for your leadership on this issue, and for convening these very important hearings.

STATEMENT OF SENATOR RUDY BOSCHWITZ

HEARING ON THE
SMALL BUSINESS INVESTMENT COMPANY PROGRAM
SMALL BUSINESS COMMITTEE
JUNE 21, 1990

THANK YOU, MR. CHAIRMAN, FOR HOLDING THIS THIRD HEARING CONCERNING THE FINANCIAL CONDITION OF THE SBA'S SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM. THE TWO PREVIOUS HEARINGS ON THIS PROGRAM WERE MOST TROUBLING.

AS YOU KNOW, DURING THOSE HEARINGS, RIVER CAPITAL CORPORATION (RIVER) WAS DISCUSSED. RIVER CAPITAL HAS DEFAULTED ON $28.5 MILLION IN SBA GUARANTEED DEBENTURES, OF WHICH ONLY $2-4 MILLION MAY BE RECOVERED. IN AN EARLIER HEARING, THE SBA INSPECTOR GENERAL (IG) INFORMED US HE BELIEVES RIVER CAPITAL UTILIZED QUESTIONABLE ACCOUNTING PRACTICES. SPECIFICALLY, OVERDUE INTEREST WAS NOT WRITTEN OFF, AND WAS CONVERTED INTO SECURITIES INSTEAD. ARTHUR ANDERSEN WAS RIVER CAPITAL'S ACCOUNTANT, AND IT IS ALLEGED THEY PERFORMED SUBSTANDARD AUDITING WORK.

IT IS ALLEGED ARTHUR ANDERSEN DID NOT DISCLOSE THAT RIVER CAPITAL ALLOWED INTEREST TO ACCRUE EVEN THOUGH COLLECTION WAS DOUBTFUL; THEY DIDN'T DISCLOSE THAT RIVER CAPITAL'S PORTFOLIO VALUATION WAS UNREASONABLE; AND THEY DIDN'T DISCLOSE THAT IT'S UNDERLYING DOCUMENTATION WAS INADEQUATE TO SUPPORT THE PORTFOLIO VALUATION.

IT IS BELIEVED BY THE INSPECTOR GENERAL THAT ARTHUR ANDERSEN DIDN'T PROPERLY ANALYZE RIVER CAPITAL'S DOCUMENTATION VALUING ITS INVESTMENTS. THIS DOCUMENTATION REFLECTED THAT THE FINANCIAL CONDITION OF MANY FIRMS WAS POOR AND DID NOT SUPPORT THE VALUES DETERMINED BY THE RIVER CAPITAL'S BOARD OF DIRECTORS.

I AM AWARE THAT ARTHUR ANDERSEN USES GENERALLY ACCEPTED AUDITING STANDARDS (GAAS); HOWEVER, THE IG USES GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS (GAGAS). GAAS REQUIRES ONLY A REPORT ON THE COMPANY'S FINANCIAL STATEMENT. GAGAS REQUIRES TWO ADDITIONAL REPORTS. ONE IS ON COMPLIANCE WITH LAWS AND REGULATIONS, AND THE OTHER IS ON THE COMPANY'S INTERNAL CONTROLS. THIS DIFFERENCE IN STANDARDS MAY BE RESPONSIBLE FOR SOME OF THE AUDITING PROBLEMS.

FOR EXAMPLE IT IS ALLEGED THAT ARTHUR ANDERSEN DIDN'T PROPERLY DETERMINE WHETHER RIVER CAPITAL'S VALUATION METHOD CONFORMED WITH SBA REGULATIONS. THIS REPORT WOULD HAVE BEEN REQUIRED UNDER GAGAS. WE HAVE BEEN TOLD THE SBA BELIEVED RIVER CAPITAL'S BALANCES WERE ACCURATE BECAUSE OF ARTHUR ANDERSEN STATEMENTS.

MR. EDWARD JENKINS FROM ARTHUR ANDERSEN IS HERE TODAY. I AM ANXIOUS TO HEAR HIS RESPONSE TO THE IG'S ALLEGATIONS REGARDING HIS COMPANY'S ACCOUNTING WORK. ALSO, THE SBA IG, CHUCK GILLUM, IS WITH US AGAIN TODAY. I LOOK FORWARD TO HEARING OF HIS CONTINUED REVIEW INTO RIVER CAPITAL.

I ALSO WELCOME MR. BRIAN CROWLEY WHO IS DIRECTOR OF THE PLANNING AND REPORTING, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION AT THE GENERAL ACCOUNTING OFFICE (GAO). GAO HAS STUDIED THE ACCOUNTING WORK PERFORMED BY ARTHUR ANDERSEN ON RIVER AND IS PREPARED TO DISCUSS ITS REPORT HERE TODAY.

I AM MOST CONCERNED ABOUT THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM IN GENERAL AND RIVER CAPITAL IN PARTICULAR. IT IS OBVIOUS CURRENT ACCOUNTING PROCEDURES ARE NOT ADEQUATE TO PROTECT THE GOVERNMENT'S INVESTMENT. WE MUST DETERMINE HOW THIS CAN BE CORRECTED IN ORDER TO ERADICATE SITUATIONS SUCH AS THAT WHICH OCCURRED WITH RIVER CAPITAL CORPORATION.

THANK YOU, MR. CHAIRMAN.

STATEMENT BY SENATOR ALAN J. DIXON
BEFORE THE COMMITTEE ON SMALL BUSINESS
ON PROBLEMS IN THE
SMALL BUSINESS INVESTMENT COMPANIES INDUSTRY

JUNE 21, 1990

MR. CHAIRMAN, OVER THE PAST SEVERAL WEEKS, THIS COMMITTEE HAS HELD A SERIES OF HEARINGS FOCUSING ON THE SERIOUS PROBLEMS CONFRONTING THE SMALL BUSINESS INVESTMENT COMPANIES (SBICs) INDUSTRY. THESE HEARINGS HAVE REVEALED AN ALARMING INCREASE IN THE FAILURES OF SBICs IN RECENT YEARS. THERE ARE CURRENTLY 170 SBICs IN LIQUIDATION -- NEARLY THIRTY PERCENT OF THE ENTIRE INDUSTRY. IN ADDITION, THE FEDERAL GOVERNMENT IS FACING THE POTENTIAL EXPOSURE OF OVER $560 MILLION DUE TO THE LOSSES FROM SBIC DEFAULTS.

WHILE THE MAGNITUDE PALES WITH RESPECT TO THE SAVINGS AND LOAN DISGRACE, OR THE HOUSING AND URBAN DEVELOPMENT (HUD) SCANDAL, SBIC FAILURES CAUSE CONSIDERABLE HARM TO AN EXTREMELY IMPORTANT SEGMENT OF THE AMERICAN ECONOMY -- SMALL BUSINESS. SMALL BUSINESS OWNERS ARE FACING AN ENVIRONMENT IN WHICH NEW CAPITAL IS DRYING UP AND EXISTING CREDIT LINES ARE BEING REDUCED OR CALLED DUE. LOSSES RESULTING FROM SBIC DEFAULTS ARE STEALING AWAY THE MONEY OUR WEAKENING ECONOMY SO DESPERATELY NEEDS. AT THE SAME TIME, SBIC FAILURES, AS WELL AS THE S&L AND HUD SCANDALS, ATTEST TO A DECADE OF UNACCOUNTABILITY, MISMANAGEMENT, AND NEGLECT. THERE ARE NO EXCUSES -- THE REGULATORY

RESPONSIBILITIES ON THE PART OF THE EXECUTIVE BRANCH MUST BE RENEWED AND STRENGTHENED!

AS INSPECTOR GENERAL GILLUM ALLUDED TO IN HIS TESTIMONY BEFORE THIS COMMITTEE ON MARCH 8 OF THIS YEAR, A THIRTY PERCENT FAILURE RATE IS SYMPTOMATIC OF A PROCESS THAT IS OUT OF CONTROL. THE IMPORTANT QUESTION IS HOW DO WE REGAIN CONTROL? ROYAL BUSINESS FUNDS CORPORATION AND RIVER CAPITAL CORPORATION BOTH OFFER LESSONS TO BE LEARNED. WE MUST EXAMINE BOTH THE MECHANISMS THAT CAUSED THEIR DEMISE AND THE SYSTEMIC PROBLEMS WITHIN THE SMALL BUSINESS ADMINISTRATION THAT ALLOWED THESE TWO, AS WELL AS OVER 170 OTHER SBICs, TO FAIL.

PAST TESTIMONY HAS POINTED OUT SEVERAL SHORTFALLS IN THE AUDITING PROCEDURES CONCERNING SBICs. OF GREAT CONCERN, AND THE FOCUS OF TODAY'S HEARING, IS THAT THE PROGRAM'S LAST SAFETY NET - AN ANNUAL DRAFT AUDIT OF SBICs BY INDEPENDENT ACCOUNTANTS - IS NOT CATCHING THE PROBLEM COMPANIES WHICH ARE MISSED BY THE SMALL BUSINESS ADMINISTRATION (SBA). THESE AUDIT PROBLEMS ARE TRULY SIGNIFICANT AND MUST BE CORRECTED. A SOLID AUDIT PLAN IS ESSENTIAL TO ENSURE THE INTEGRITY OF THE PROGRAM. WE MUST NOT ALLOW THESE AUDITING PROCEDURES, HOWEVER, TO OBSCURE THE UNDERLYING CAUSE OF SBIC FAILURES -- THE BEWILDERING TENDENCY OF MANY SBICs TO BACK MORE LOSERS THAN WINNERS.

I FIRMLY SUPPORT THE SBIC CONCEPT OF PROVIDING FINANCING OF LAST RESORT TO MODERATE AND HIGH RISK BUSINESS VENTURES.

OVERWHELMING SUCCESSES SUCH AS NIKE, FEDERAL EXPRESS, AND APPLE COMPUTERS ATTEST TO THE VALIDITY OF THIS CONCEPT. UNFORTUNATELY, IT APPEARS THAT THESE SUCCESSES ARE THE EXCEPTION AND NOT THE RULE. OUR GOAL SHOULD BE TO PROVIDE THE MOST SUCCESSFUL BUSINESS VENTURES WITH THE CAPITAL AVAILABLE. TO ACCOMPLISH THIS GOAL, THE SBA MUST TAKE A MORE PROACTIVE ROLE IN ESTABLISHING SOLID PRACTICES AND PROCEDURES FOR THE SBICs IN ORDER TO GUARANTEE A BETTER INVESTMENT SELECTION PROCESS. WE CANNOT EXPECT EVERY INVESTMENT TO SUCCEED, BUT ONLY THROUGH MORE PRUDENT SELECTION OF INVESTMENT OPPORTUNITIES CAN WE ENSURE THE CONTINUANCE OF SMALL BUSINESS INVESTMENT PROGRAMS.

WE IN CONGRESS MUST BE ASSURED OF THE RELIABILITY OF THE OVERALL SBIC HEALTH ASSESSMENT FIGURES. FROM WHAT WE HAVE SEEN, THE VALUATION POLICIES AND PROCEDURES ARE NOT PROVIDING AN ACCURATE PICTURE OF THE REAL FINANCIAL CONDITION OF THE SBIC PROGRAM. THIS SENATOR WILL NOT SUPPORT ANY FURTHER EXPANSION INITIATIVES UNTIL THE SBA PROVIDES THIS COMMITTEE WITH THE TRUE FISCAL EXPOSURE AND A PLAN ON HOW IT WILL IMPROVE THE PERFORMANCE OF SBICs.

I WOULD LIKE TO COMMEND THE CHAIRMAN FOR HOLDING THIS THIRD HEARING ON PROBLEMS IN THE SBIC PROGRAM, AND I LOOK FORWARD TO THE THOUGHTS AND RECOMMENDATIONS OF MESSIEURS GILLUM, CROWLEY AND JENKINS FOR IMPROVING THE SUCCESS RATES OF SBICs.

The CHAIRMAN. Thank you, Senator Lieberman.

Mr. Crowley, one other thing. You stated that in October 1989 that the SBA General Counsel and the Assistant U.S. Attorney both asked the Inspector General not to issue the final audit report to avoid any potential impact on possible future litigation against River Capital officials and Arthur Andersen. But in a television interview the General Counsel stated that she had no idea why the IGA did not finish the report. Do you have any idea why she might have said that?

Mr. CROWLEY. No, I do not. Do you?

Mr. CLARK. No, I do not have an idea why she would have said that.

Mr. CROWLEY. We checked over there with the Assistant or the SBA General Counsel, just before this testimony and found out that, at least, they were still—

Mr. CLARK. They were still pending before the General Counsel, and they had not made a decision on what action they were going to take with respect to River Capital.

Mr. CROWLEY. We talked to the General Counsel's office, right?

Mr. CLARK. Right.

The CHAIRMAN. Is that where you got the information that they had asked the IG not to issue the final report?

Mr. CROWLEY. Yes.

Mr. CLARK. I am not sure who gave us that information. That may have been through conversation with the Inspector General.

The CHAIRMAN. And not from the General Counsel's office?

Mr. CLARK. We would have to check on that, Mr. Chairman.

The CHAIRMAN. Which takes precedence? The American Institute of CPA's Audit Guide for Investment Companies or the Generally Accepted Auditing Standards?

Mr. CROWLEY. Generally Accepted Auditing Standards. But as I said, the profession relies solely, or tremendously, on the guides themselves to carry out these audits. In fact, some will tell you that they are the same thing.

The CHAIRMAN. Yes. On page 5 of your testimony you state that the AICPA audit guide itself requires a five-step procedure for the auditors to follow. Now, did you look at these steps individually to see if each was followed in this case?

Mr. CLARK. Yes, we did.

The CHAIRMAN. You did?

Mr. CLARK. Yes. That was by——

The CHAIRMAN. Did you find that they were?

Mr. CLARK. In our opinion, they were followed by Arthur Andersen. That is based on our review of the working papers and conversations with Arthur Andersen.

The CHAIRMAN. In following those steps, did you find anything that would cause you to think that Arthur Andersen should have gone behind a particular procedure? I mean, did any of these procedures reveal to you what you would have considered to have been a red flag that should have been put in their final report?

Mr. CROWLEY. Mr. Chairman, if I might digress here a little bit, if GAO had done this job, it would have been done differently. You asked us to look at it from the standpoint of whether they were meeting standards. If we were doing it, we would have gone behind the information and gotten more information. I can guarantee you that. And there were things that we, as GAO, would look further into, yes.

The **Chairman**. Well, I hope that you and the Inspector General will be able to get together forthwith. It would not take an awful lot of time for you to go over carefully with him with your recommendations. And I certainly hope that he will adopt those recommendations in this 60- to 90-day review period that we have just been talking about here.

Mr. **Crowley**. Mr. Chairman, these are not new recommendations. These were made before. We made them before. The IG has done some work to implement some of these, but it is just not all in place yet. We will get together with him and see if we can expedite getting these things in place. He has testified before you that he agrees with all of them and thinks that they should be done.

The **Chairman**. I tell you, the thing that is so frustrating about this is I keep getting the information, you know, that we are working on this, and we are going to do this, we are going to do that, and yet it just does not seem to take place.

Mr. **Crowley**. You know, SBA——

The **Chairman**. I want to compliment the IG, do not misunderstand me.

Mr. **Crowley**. OK.

The **Chairman**. I am not picking on him, because he did do this study that I requested him to do as quickly as possible. And he has done it, and I think the information he has presented here this morning is very helpful to us. When we learn that 23 out of 50 SBICs of over $5 million leverage are in trouble, you know, that is a real red flag.

Mr. **Crowley**. Sure.

The **Chairman**. So I appreciate him having done that. But I am not sure, and I am not—actually, it is the SBA——

Mr. **Crowley**. That is correct.

The **Chairman** [continuing]. That I am concerned about, not the IG.

Mr. **Crowley**. That is correct.

The **Chairman**. And their attitude about this whole thing.

Mr. **Crowley**. And it is the SBA that needs to require that these audits be done in accordance with GAGAS, and that they be done in accordance with the IG's guidelines.

The **Chairman**. Yes. Staff tells me that Administrator Abdnor, Senator Abdnor, when he was head of the SBA declined to implement GAO's recommendations in 1987 because of the cost. Are you familiar with that?

Mr. **Crowley**. I am familiar with the fact that he took exception to our recommendations. I do know that the IG agrees with us. I do not think cost is a factor here. I think doing the job right is a factor. It is costing us a lot of money not to do it right.

The **Chairman**. Well, Mr. Crowley, I really appreciate your testimony. I appreciate your last statements. You and I are certainly on the same wavelength. Even if it does cost a little bit more, the money would be well spent.

Thank you both very much for being with us this morning.

Mr. **Crowley**. You are welcome, sir.

The **Chairman**. Our next witness is Edmund Jenkins of Arthur Andersen & Co.

Mr. Jenkins, thank you very much for coming to be with us this morning to give us Arthur Andersen's side of the story. So, please, proceed.

STATEMENT OF EDMUND L. JENKINS, PARTNER, ARTHUR ANDERSEN & CO.

Mr. **Jenkins**. Thank you, Mr. Chairman, Senator.

I appreciate the opportunity of being here this morning. We have submitted a statement for the record, and I would request that you accept it for the record.

The **Chairman**. It will be admitted to the record.

Mr. **Jenkins**. Thank you.

The **Chairman**. It is a lengthy statement. If you can summarize it, it will be helpful.

Mr. **Jenkins**. I have a summary, and I would like to make a few opening remarks, thank you.

During the hearings that you have held on the SBA's SBIC Program, questions have arisen concerning Arthur Andersen's audits of the 1986 and 1987 statements of River Capital Corp. River Capital was an SBIC which, subsequent to our audits, defaulted on its SBA loans in 1988 and went into bankruptcy in 1989. You and others on this Committee have asked whether independent audits of SBA financial statements provide as much useful information as they might.

These questions have focused attention upon the role of the independent auditor with respect to the valuations of investments held by SBICs like River Capital. We believe these questions are important, and we take our professional responsibility seriously. And that is the reason we have asked for an opportunity to meet with you this morning to discuss these issues.

In order to understand the responsibilities of independent auditors with respect to an SBIC's investment valuation decisions, we must first understand the unique environment in which they operate. The special mandate of SBICs is to be an investor of last resort, as we heard this morning, to provide financial support to enterprises that are unable to attract traditional commercial financing.

The enterprises in which an SBIC invests are usually start-up enterprises, enterprises which are not expected to break even, to say nothing of making profits or generating significant cashflows for several years. These are entities which must be nurtured and supported, often for significant periods of time.

As a result, investments made by SBICs are not susceptible to traditional market-based valuation procedures. There is almost never an effective market for these investments. In recognition of this fact, generally accepted accounting principles and the SBA regulations provide that SBIC investments are reported at their fair value, as determined by the board of directors. All of the relevant professional literature, including the SBA's regulations, place the responsibility for determining the fair value of an SBIC's investments solely on its management and the board.

This is because only management and the board are in a position to understand and evaluate the promises and pitfalls of these investments. All of the relevant professional literature also recognizes that these fair value determinations are of necessity highly subjective. Thus, the amount of auditing which can be done with respect to these valuations is severely limited. The professional literature, including the SBA's own regulations, expressly provide that the independent auditor is not to be an appraiser and is not to substitute its judgment concerning the value of investments for that of the board. Rather, the role of the independent auditor is only to verify two things.

First, that the process was reasonably designed to surface information upon which an appropriate valuation decision could be based. And, second, that the board actually considered that information in coming to its determinations of the fair value of the investments.

Now, given that limited role, what did Arthur Andersen do in its audit of River Capital? First, we determined that management of River Capital had assembled for the board substantial information reflecting the status of their investments, warts and all. Our review did not disclose any inaccuracies or omissions in this information.

Second, our audit partner and manager attended the meetings at which the board determined the fair values for River Capital's investments. At those meetings, they observed the active involvement in the valuation process of the directors, many of whom are sophisticated and experienced businessmen. Based on our review of the information provided the board and our observation of the board's consideration of that information, we concluded that River Capital's procedures for determining the fair value of its investments were reasonable.

Having reached that conclusion, we then issued an appropriate report on River Capital's financial statements, as the GAO has just pointed out in the previous testimony. Because the valuation decisions of the board were subject to significant uncertainty, we qualified our report to red flag that uncertainty. Under the existing regulatory framework, we then had completed our responsibilities with respect to River Capital's investment valuations.

I was happy to hear this morning the GAO's conclusions that the steps we took in the River Capital situation complied with the AICPA's Investment Company Audit Guide. The profession recognizes that this guide establishes Generally Accepted Auditing Standards for investment companies such as River Capital.

Given the importance of the investment valuation decisions to the financial statements of an SBIC—85 percent of River Capital's assets were in these kinds of investments—an obvious question is, can the outside auditor do more to assist the regulator in monitoring the financial position? Yes, we can do more; and we believe the rules should be changed so that we could.

In my formal statement, we make several specific suggestions as to changes we believe the SBA should make in its regulations in order to enhance our ability to contribute to the regulatory process. I would be happy to discuss these suggestions with you in detail.

Really, they are very consistent with the suggestions you heard just a few minutes ago from Mr. Crowley.

Very briefly, though, the suggestions that we have made in our formal statement to you are: First, that the SBA should require contemporaneous documentation of management's investment plans for each new investment. It is at the time the initial investment is made when the real risk is undertaken. This would accomplish two things. It would create a record of that decision process as a basis for evaluating the quality of management. And it would establish benchmarks against which to measure the subsequent performance of investments in the annual valuation process.

Our second suggestion is that the SBA should limit writeups of investments to situations where there has been a significant third-party transaction or where profitable performance over some period of time supports an increased value.

Third, the SBA working with the AICPA should expand the reporting opportunities for independent auditors on compliance issues and internal controls. That is a suggestion that Mr. Crowley made with respect to adopting the GAO's 1988 suggestions to SBA. And, finally, the SBA should require notice of the reasons for changes in auditors as the SEC does and other agencies are considering.

The first two suggestions would provide more objective criteria for the independent auditor's use in assessing the reasonableness of the procedures followed by the board in determining the subsequent fair value of investments. And the remaining suggestions would put the independent auditor in a position to provide the SBA with important information relating to compliance which is not provided for under the current regulatory framework.

Now these changes will not remove the risks inherent in investments made by SBICs. Audits simply do not determine the success or failure of individual investments, SBICs or any other enterprise for that matter. However, our suggestions would permit the independent auditor to be a much more important source of information for the SBA than the present limitations on the auditor's role permit. And we would welcome an opportunity to work in that direction.

Before responding to your questions, I would like to compliment you, Mr. Chairman, and this Committee for looking into this matter. I am fully aware that the current limitations on the independent auditor's contribution to the SBA's oversight function are both very technical and frustrating. Your initiatives should be very helpful in improving this situation, and I congratulate you for what you are doing.

Now I would be happy to respond to any questions you may have.

[The prepared statement of Mr. Jenkins follows:]

PREPARED STATEMENT

OF

EDMUND L. JENKINS

ARTHUR ANDERSEN & CO.

Before the

Committee on Small Business

United States Senate

June 21, 1990

Mr. Chairman and Members of the Committee:

My name is Edmund L. Jenkins and I am Managing Director--Accounting Principles for Arthur Andersen & Co. I hold an MBA from the University of Michigan and have been a Certified Public Accountant for 30 years. I have been with Arthur Andersen & Co. for 32 years and a partner for 22 of those years. In addition to my responsibilities within the firm, I am a member of the Financial Accounting Standards Board's Emerging Issues Task Force, which establishes guidance with respect to the accounting and financial reporting for contemporary transactions where existing professional guidance is absent or unclear.

Over the past several months, you have held several hearings on the SBA's oversight of its SBIC program. During these hearings, questions have arisen concerning Arthur Andersen's audits of the 1986 and 1987 financial statements of River Capital Corporation, a SBIC which, after our audits, defaulted on its SBA loans in 1988 and went into bankruptcy in 1989. Questions also have been raised about whether audits of a SBIC's financial statements provide as much useful information to the SBA as they might.

I have volunteered to come before you, representing Arthur Andersen, to discuss these issues and to address any questions you may have about my firm's audit work. In particular, I would like to talk with you about the responsibilities of an independent auditor within the existing framework of regulations and to offer our views and suggestions for certain specific changes to that regulatory framework. We believe the SBA should consider certain changes in order to enhance the contribution of the independent auditor to SBA oversight.

The issues raised in earlier testimony before this Committee about River Capital all related to its valuation of investments as reflected in its 1986 and 1987 financial statements. Thus, it is important that we discuss at the outset the respective responsibilities of management and the board of directors on the one hand, and of the independent auditor on the other, with respect to a SBIC's investment valuation decisions under the current regulatory framework.

The responsibilities of the independent auditor in investment valuation decisions can only be understood by grasping the unique environment in which SBICs operate. Their mandate is to be the investors of last resort -- they support enterprises that are unable to attract traditional commercial support. SBICs invest in enterprises that typically have no significant operating experience; often, enterprises in a "start-up" mode that are not expected to break even for several years -- to say nothing of making profits or generating significant cash flow. The only companies in which SBICs are permitted to invest are those changing directions and exploring new frontiers -- investments which are being supported precisely because they are novel, innovative and entail high risk.

As a result of this orientation, the investments made by SBICs are not susceptible to traditional market-based valuation procedures. Indeed, there is almost never an effective market for these investments. In recognition of this fact, Generally Accepted Accounting Principles ("GAAP") and specific SBA regulations provide that the investments made by SBICs are to be reported at "fair value."

Because of the unique nature of these investments, the SBA, the SEC and the accounting profession all recognize that such "fair value" determinations must necessarily be highly subjective. There simply are no objective and quantitative criteria which can be imposed as reliable measures of the value of these investments. For this reason, these bodies have all avoided establishing arbitrary quantitative rules to govern the valuation of investments. Instead, the oversight bodies have relied on the subjective judgment of management and the board of directors.

SBA regulations require only that a board make its valuation judgments in "good faith." Noting that "no single standard for determining fair value can be laid down...," the SBA's guidance is extremely general. The SBA's 1975 Valuation Guide permits consideration of any of a number of possible valuation factors. Neither those guidelines nor other SBA regulations require any specific procedures to be followed. Rather, the SBA relies on the board to decide how to value the SBIC's investments, providing only a general presumption favoring valuation of these investments at "cost." (See APP. I, Section I of SBA Regulations and the 1975 SBA Valuation Guide, SBA Policy and Procedure Release 2006.)

The SBA, the SEC and the accounting profession all recognize that the responsibility for determining the "fair value" of a SBIC's investments properly resides solely with its management and board of directors. This view is appropriate because only management and the board are in a position to understand and evaluate the promises and pitfalls of these investments.

We concur with that general premise and with the SBA's long-standing posture of refraining from imposing arbitrary valuation criteria on the valuation decisions of management and the board. However, we also believe that some changes can and should be made to the regulatory framework for determining fair value. More precise procedural limitations can be given to management and the board without depriving them of the flexibility required in this industry. I will describe those changes shortly. Before turning to that subject, however, I would like to discuss the role given the independent auditor with respect to these investment valuation decisions.

Generally Accepted Auditing Standards (GAAS) and the current regulatory framework limit the auditor's role to determining the reasonableness of the procedures by which the board reaches its valuation decisions. Indeed, the SBA's own regulations expressly provide that "the auditor is not to be an appraiser" and is not to substitute its judgment on the value of investments for that of the board. Rather, the independent auditor is only to verify that the process followed was reasonably designed to surface information upon which an appropriate decision could be based -- and that the board actually considered that information in determining the fair value of investments. (See APP. I, Section J of SBA Regulations.)

The independent auditor is not responsible for the valuations themselves. To underscore this point, I have attached in Appendix A excerpts from the American Institute of Certified Public Accountants Investment Company Audit Guide and from the United States Securities and Exchange Commission's Codification of Financial Reporting Policies. Both excerpts support the SBA's own regulations, which place responsibility for valuation decisions solely with the board of directors and note that the auditor is not to act as an appraiser, substituting its judgment for that of the directors with respect to the fair value of investments.

I also have attached as Appendix B a copy of Arthur Andersen's report with respect to the 1987 financial statements of River Capital Corporation, along with footnotes three and four to the financial statements, which are specifically referred to in our report. The opinion we provided in connection with our audit of River Capital's financial statements was a qualified opinion. This opinion clearly informed readers that the investment valuations were solely based on the board's subjective judgments and were, in Arthur Andersen's view, uncertain. Our report "red-flags" the inherent uncertainty in those values and specifically emphasizes the fact that the board's estimates of value may differ significantly from the values that would have been reported had an effective market existed for the securities.

In these hearings, the question has been asked whether Arthur Andersen adequately performed its responsibilities with respect to valuation decisions at River Capital. Now that we have laid out the auditor's role in this process, let's look at what Arthur Andersen did in its audit of River Capital.

First, Arthur Andersen determined that River Capital's management had assembled substantial financial information regarding its investments for the board's review. Arthur Andersen's review of those materials indicated that the circumstances relating to River Capital's investments were clearly laid out -- warts and all -- for the board. Our review did not disclose any inaccuracies in this information.

Second, Arthur Andersen determined that the board's review of these materials was neither cursory nor cavalier. To the contrary, Arthur Andersen determined that River Capital's board sat down with management and discussed the investments individually before coming to a decision.

More specifically, in connection with each audit, the Arthur Andersen audit partner and manager attended the entire meeting each year at which the board discussed River Capital's investments. Through their attendance at those meetings, the auditors observed directly the active involvement of River Capital's directors in the valuation decisions. The audit partner and manager observed that the board was no "rubber stamp." The board did not agree with every management recommendation on valuations. To the contrary, the directors, many of whom are very sophisticated and experienced businessmen, actively questioned management on each investment; in consequence, certain valuations were changed. After observing this procedure, Arthur Andersen concluded that management and the board followed reasonable procedures in making their decisions on the fair value of River Capital's investments, although we also observed that the board's valuation decisions were subject to significant uncertainty.

Under the current regulatory framework, those observations -- that River Capital's procedures for determining the fair value of its investments were reasonable, but that the fair value determinations themselves were uncertain -- were the only ones that Arthur Andersen was permitted to offer.

Given the importance of the investment valuation decisions, an obvious question is, "Can the independent auditor do more to assist the regulator in monitoring the financial position of SBICs?" We believe the answer is "Yes." Changes can and should be made to the SBA's regulations which would give the independent auditor additional tools and responsibilities so that we can provide more helpful information. We offer four specific suggestions for your consideration:

(1) Require contemporaneous documentation by management of investment plans for each new investment;

(2) Limit write-ups in value to situations where a significant third party transaction or profitable performance supports an increased value;

(3) Expand reporting opportunities for independent auditors on compliance issues and internal controls;

(4) Require notice of changes in auditors.

With your permission, I would like to discuss briefly each of these recommendations.

We noted earlier the long-standing position of the SBA and others -- including the SEC and the accounting profession -- that it would be inappropriate to establish arbitrary rules to replace the board's judgment of the fair value of investments. Due to the nature of these investments, we agree it would be inappropriate to try to impose ratios or other arbitrary quantitative criteria on the valuation process. However, we believe the SBA could require, through two regulatory changes, a highly desirable degree of discipline and conformity in both the investment and valuation decision-making processes.

First, we suggest that the SBA require management to document the explicit basis for each investment it enters into at the time the investment decision is made. The SBA should require that this documentation include management's projections, plans and timing expectations for each investment. This regulation would accomplish two things:

A. It would create a record of the investment decision process to which the board and the SBA could refer in evaluating the quality of management's decisions. If subsequent experience were to show that projections, plans and timing expectations are not being met, that fact should bring into question the quality of management's decisions, which in turn should affect the decisions by the board and the SBA with respect to future operations of the SBIC. This is particularly important in the "investor of last resort" environment in which a SBIC operates because losses can only really be controlled in a SBIC by controls on initial investment decisions.

B. In addition, creation of this record of investment decisions and expectations would give management and the board specific benchmarks against which to measure later performance of individual investments. Whether an investment is "on track," based on the

> documented expectations of management at the time an investment is made, could become a key inquiry required of the board. The SBA could provide by regulation that, without compelling evidence to the contrary, an investment should be written down if management's initial documented expectations are not being met. This documentation of initial investment expectations and subsequent performance measurements would become part of the auditor's review in determining whether the board's investment valuation procedures are reasonable.

We believe that such a regulatory requirement would be a significant positive step improving one side of the valuation decision -- the decision to hold at cost or write-down an investment. Write-ups of an investment pose a different problem. We propose a second regulatory change to deal with this.

Under Generally Accepted Accounting Principles and the SBA's regulations, management and the board may increase the "fair value" at which an investment is carried on the company's books if they believe, in good faith, that such a write-up is appropriate. However, there are no specific criteria controlling when an investment can be written up.

We believe the SBA should require by regulation that, in the absence of compelling contrary evidence, write-ups should not be permitted until

A. There is a significant transaction with an independent third party (such as the sale of equity securities) which supports the write-up, or

B. The company has completed its start-up phase and has a successful operating history.

These two changes in current SBA regulations would add substantial discipline to the subjective areas of investment and valuation decisions without subjecting management to the straitjacket of arbitrary quantitative rules which are inappropriate in the "investor of last resort" environment of the SBIC. At the same time, these changes would permit the independent auditor to monitor the application of substantially more quantitative and objective standards to the ongoing decisions of management and the board concerning the fair value of a SBIC's investments.

In order to make these proposed regulations truly effective, we suggest a third regulatory change. The SBA should adopt certain concepts outlined in the 1988 GAO report, entitled "CPA Audit Quality", which would remove some of the limitations that currently exist on the role of the independent auditor.

Currently, the SBA regulations require SBICs to retain an independent auditor to perform an audit in accordance with Generally Accepted Auditing Standards ("GAAS") of financial statements prepared in conformity with Generally Accepted Accounting Principles ("GAAP"). Operating within this framework, the only communication between the auditor and the regulators is the standard auditor's report on those financial statements. Under GAAS, our duty of confidentiality to our client limits our ability to comment on other matters that may be of interest to the SBA. As a result, the auditor's real contribution to the SBA's oversight activities is not all that it could be.

Under the current framework, the independent auditor has no avenue by which it may report on any number of matters which fall outside the ambit of a GAAS audit of GAAP financial statements. We believe that this situation should be changed and that opportunities for communications between the independent auditor and the SBA should be increased. Specifically, we endorse the GAO's recommendation that audits of SBICs be performed in accordance with Generally Accepted Government Auditing Standards (GAGAS). That requirement would provide for the preparation of additional reports by the auditor that could significantly assist the SBA.

Under the current framework, the independent auditor cannot report any failure of a SBIC to comply with SBA regulations unless such noncompliance has a material impact on the financial statements -- and even then, only if it has not been accounted for properly. Government Auditing Standards, however, provide for preparation of a separate report by the SBIC's independent auditor addressing compliance -- regardless of whether noncompliance would affect the fair presentation of the financial statements. That report would include, among other things, a positive opinion on items tested and disclosure of any identified instances of noncompliance with regulations. Furthermore, the SBA could require that specific agency regulations be tested and that the auditor's report on compliance include a statement specifically addressing the SBIC's compliance with those designated regulations. Such a regulatory requirement could provide for compliance testing of matters not typically subjected to specific audit procedures in a GAAS or GAGAS audit -- e.g., items that would not have a direct and material effect on the financial statements.

Government Auditing Standards also require preparation of a written report by the independent auditor describing the internal controls reviewed, those not reviewed, and any material weaknesses in internal controls identified during the audit. Under Generally Accepted Auditing Standards, the auditor is not required to report material weaknesses separately or to describe the extent of any controls review.

The current regulatory framework does not provide for application of Government Auditing Standards or additional tests of compliance with specific regulations in SBIC audits. Without such requirements, the independent auditor has no vehicle to provide the SBA with the kind of information contemplated in the reports we suggest.

A SBA requirement of compliance with such reports would put the independent auditor in a position to provide substantial assistance to the SBA by providing comprehensive annual coverage of all SBICs, identifying potential areas of concern on a timely basis and enabling the SBA to concentrate on the real problems of the agency. To accomplish this effectively, the SBA and the AICPA should work together to develop an amendment to the AICPA Industry Audit Guide that identifies specific regulations to be tested for compliance and to develop sample audit procedures for the auditor to consider.

Our fourth suggestion is that the SBA require SBICs to give the Agency notice of changes in auditors. The SEC already has this requirement; other regulatory agencies are considering a rule. Notification of a change in auditors, together with a description of the reasons for such a change and disclosure of any disagreements between the auditor and the management of the SBIC could provide the SBA with an important opportunity to address potentially troublesome situations.

These suggested changes will not remove the risk inherent in the investments made by SBICs. Indeed, no action or report issued by an independent auditor can affect the financial risks accepted by a SBIC once it has made an investment. Audits do not determine the success or failure of an individual investment, a SBIC or any other enterprise. However, we believe the changes we suggest would provide regulators with important new information that would be useful in monitoring SBIC activities. Furthermore, although our suggested changes would not alter the nature of the auditor's responsibilities with respect to investment valuations, they would provide more objective criteria which the independent auditor could use to assess the reasonableness of the procedures followed by management and the board in determining the fair value of investments.

In summary, we believe that:

(1) Arthur Andersen fulfilled its responsibilities with respect to the decisions of management and the board concerning the valuation of River Capital's investments within the limits created by the current regulatory framework;

(2) That regulatory framework can and should be changed to increase and enhance the contribution of the independent auditor to the SBA's oversight efforts; and

(3) The four changes to the regulatory framework which we have suggested would materially improve the situation by providing important new information to the SBA.

We hope that these comments and suggestions will prove helpful to you and your efforts to deal with this very difficult situation. Thank you for this opportunity to present our views.

Appendix A

The Role of the Independent Auditor

The American Institute of Certified Public Accountants Investment Company Audit Guide states:

> "The independent auditor does not act as an appraiser for security values estimated in good faith by the board of directors, and is not expected to substitute his or her judgment for that of the fund's directors. Instead, the auditor should review the company's procedures for its continuing appraisal of such securities, determine whether the methods established for valuation are followed, and make certain that these methods have been reviewed and approved currently by the board of directors."
>
> (excerpt from Sec.2.144)

The United States Securities and Exchange Commission's Codification of Financial Reporting Policies sets out the same standard:

> "In the case of securities carried at 'fair value' as determined by the board of directors in 'good faith,' the accountant does not function as an appraiser and is not expected to substitute his judgment for that of the company's directors; rather, he should review all information considered by the board or by analysts reporting to it, read relevant minutes of directors' meetings, and ascertain the procedures followed by the directors."
>
> (excerpt from Sec.404.03.c.)

Appendix B
Page 1 of 2

ARTHUR ANDERSEN & CO.
WASHINGTON, D. C.

To the Board of Directors of

River Capital Corporation:

We have examined the statements of financial position of RIVER CAPITAL CORPORATION (a Delaware corporation - formerly RIHT Capital Corporation), including the statements of loans and investments, as of December 31, 1987 and 1986, and the related statements of operations, changes in stockholders' equity and cash flows for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, including the inspection and confirmation of securities purchased and received as of December 31, 1987 and 1986.

As discussed in Note 3, the financial statements include investment securities valued at $33,602,666 and $28,216,708 at December 31, 1987 and 1986, respectively, (85% and 83% of total assets, respectively) whose values have been estimated by the board of directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the directors in arriving at their estimate of value of such securities and investments and have inspected underlying documentation, and in the circumstances, believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the board of directors' estimate of values may differ significantly from the values that would have been used had a ready market existed for the securities, and the differences could be material. Further, as discussed in Note 4, the financial statements include $4,670,716 and $3,657,225 at December 31, 1987 and 1986, respectively, of net interest receivable, realization of which is dependent upon the future operations and cash flow of the portfolio companies or disposition of the related investments at amounts sufficient to recover the investments and interest receivables. The board of directors has reviewed this interest receivable as part of the aforementioned valuation of investments.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had a ready market existed for the securities referred to in the preceding paragraph or as might have been required to the interest receivable had a different valuation been determined for the investment security, the financial statements referred to above present fairly the financial position of River Capital Corporation at December 31, 1987 and 1986, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

February 25, 1988.

Arthur Andersen & Co.

(3) BOARD OF DIRECTORS' VALUATION OF LOANS AND INVESTMENTS

Securities amounting to $32,021,810 and $28,216,708 at December 31, 1987 and 1986, respectively, have been stated at fair value as determined by the Board of Directors. The values assigned to the investments are considered to be the amounts which could be realized from an orderly sale or other disposition of the investments over a reasonable period of time.

In making its valuation, the Board of Directors took into account the cost of the investments to the Corporation, developments since the acquisition of the investments and other factors generally pertinent to the valuation of investments. There is no public market for most of the investments; the markets for the other investments are not wide. The Board, in making its evaluation, has in many instances relied on financial data of investees and on estimates by management of the Corporation and the investee companies as to the effect of future developments. The Board has reviewed such documentation as is available. The basis for the valuations is believed to be in accordance with the guidelines enumerated in SBA Policy and Procedural Release #2006 - Valuation Guide, revised November 1975.

(4) INTEREST RECEIVABLE

The Corporation accrues interest on debt securities from portfolio companies in accordance with the terms of the debt instruments. A substantial amount of such accrued interest is not being paid on a current basis and is past due; realization or collection is dependent upon the portfolio companies' ability to achieve a level of operations or cash flow to repay the Corporation, or the Corporation's ultimate disposition of its investments at amounts sufficient to recover all amounts invested, including accrued but unpaid interest. As part of its ongoing valuation of loans and investments, the Corporation's management and board of directors reviews the interest receivable, and the Corporation provides a reserve for amounts it deems to be uncollectible.

Also, from time to time, the Corporation may restructure certain loans or investments and, in connection therewith, convert related interest receivables into an equity or preferred interest position. Of the total $6,670,715 interest receivable at December 31, 1987 (before reserve for loss), the Corporation anticipates that approximately $3,579,000 will be converted as aforementioned.

The CHAIRMAN. Thank you. Thank you very much for being with us this morning, Mr. Jenkins. I know that considering the fact that there may be pending litigation between SBA and Arthur Andersen, it is a tough assignment for you. And this is not an inquisition; this is an oversight hearing to find out what we have been doing wrong that has allowed a really sizable loss to the Government to occur.

And this is like a lot of other things around here. We find out sometimes too late that the procedures that have been used simply were not adequate. I know that this is like an old expression I used to hear as a child in Arkansas, everybody's business is nobody's business; as long as it does not affect a single individual a lot, then everybody just rolls along with it.

And I can remember when I found out the Government—in 1978, I found out the Government was and had for many, many years been leasing its oil and gas lands for a dollar an acre, first come, first serve. It sounded too egregious for me to believe. I started digging into it, and I found out the Government lost billions and billions of dollars with an antiquated 1920s lottery system of leasing 350 million acres of land for oil and gas exploration.

And now we have got mining laws, the bill was signed by President Grant, still in place. When mining companies go out West, stake claims for hundreds of acres of land, go in and start mining it without even putting up a bond, do not pay a dime royalty to the Federal Government and walk off and leave an environmental disaster for the taxpayers to pick up.

That is very difficult for the people in this audience; it is difficult for me to believe. But that situation is still in existence. What is even more difficult is my bill to revise all of that will probably take about 8 years—that is how long it took me to revise the oil and gas leasing laws—8 years. It will probably take 8 years to change the mining laws.

But if it takes that long to revise our accounting system and our method of valuating the stock of these SBICs, we will lose a tremendous amount of money. This is just one of those things that all of us now recognize that the method of valuating investments held by SBICs is the most seriously flawed part of this whole program.

And so I am not going to suggest that Arthur Andersen was negligent or that it was right on top of the situation. It may be that the GAO has given you pretty good ammunition by saying that you did, in fact, follow the accounting procedures that you were required to follow. But by the same token, these hearings have shown that those procedures, if indeed they were followed, are very seriously flawed. And they must be corrected, and they must be corrected immediately.

The thing, I think, that perplexes me more than anything else, Mr. Jenkins, and I would just like your comments on that, and that is that fair value of these portfolios is to be determined solely by a good-faith effort of the board of directors. Now to me that is a classic case, of course, of the fox watching the hen house.

I mean, I have given banks—I was a small businessman for 18 years—and I have given banks financial statements once or twice a year all of my life. And usually when I put down the top item, cash, how much cash I have, and I list the two or three banks that

I bank with and how much I have in each one, that may or may not be right. And if they have any cause at all for concern, they are going to call the bank and say, does Dale Bumpers have this much cash in your bank?

And in this particular case, it seemed to me that it would have been, you know the prudent thing, just common sense would have dictated that three or four of these valuations should have been checked out in some detail just to see whether the board was reasonable in its valuations.

But because of this possible litigation, and so on, I think, we have gotten all the information we need. I do not know of anything frankly more than I could ask you, Mr. Jenkins.

So, Senator Lieberman, I will turn it to you.

Senator **Lieberman**. Well, again, I do not really have questions. I think your statement has been good and speaks for itself and points us in a direction.

You know, if the audits are being—what you really say goes to the heart of the problem. If the audits are being performed according to the generally accepted auditing practices, and those standards are inadequate to this task, then we obviously do not have a firm standard to measure the health of these SBICs.

I just want to draw from one part of your longer statement, where you talk about the fact that you are operating within the GAAS. And you are saying that, "Operating within this framework, the only communication between the auditor and the regulators is a standard auditor's report on these financial statements. Under GAAS our duty of confidentiality to our client limits our ability to comment on other matters that may be of interest to the SBA. As a result, the auditor's real contribution to the SBA's oversight activities is not all that it could be. Under the current framework, the independent auditor has no avenue by which it may report on any number of matters which fall outside the ambit of a GAAS audit of GAAP financial statements."

That is a pretty strong statement. Do you want to explain all that? I mean, I think you really put your finger on it right there.

Mr. **Jenkins**. Yes, Senator. I think that is exactly why we are suggesting, as the GAO has suggested and as the Inspector General has suggested, that the SBA change its requirements with respect to auditors, so that the auditors can go beyond the limitations that they now have.

We kind of have a couple of levels at which we could audit. We now have a Generally Accepted Auditing Standards level, under which we are limited in our ability to report to what we can say in our auditor's opinion, a portion of which the GAO read to you and which is attached to my statement as well.

Then we have the possibility of adopting Government auditing standards as a part of the independent auditor's role. And that goes beyond GAAS and gives explicit permission to the independent auditor to do additional work and report additional findings. The auditor's client, the SBIC, knows that at the time it makes the arrangement with the auditor, so it is not a breach of confidentiality because it has been arranged in advance. That provides the independent auditor with the opportunity to make two more reports.

One goes to any lack of compliance with the SBA's regulations in this case, but it could be any regulatory agency. But with respect to the SBA's regulations in this case, any failure to comply with those regulations that the auditor comes upon during his audit would be reported. And it also permits the auditor to comment directly and in a separate report on any material inadequacies in internal control that may exist.

So now we have the second level, beyond the GAAS level into the Government auditing standards level. And there even is a third level. And that is where the auditor would specifically test for specific—compliance with specific regulations. And that would be an arrangement that would be worked out between the SBA in this case and the profession to focus on specific regulations that would be deemed to be particularly important and within the auditor's purview.

And what we are suggesting is to go through those steps, have the SBA go through those steps and, working with the AICPA, determine what would be appropriate, so that indeed the auditor can do more than we are permitted to do under the first level.

Senator LIEBERMAN. Let me just, your answer—and I appreciate your forthrightness and the constructive tone in which you are speaking. Let me just ask you this baseline question. Is there an inherent conflict in asking your or any auditing firm, as an independent auditor retained by the SBIC to do these audits, as opposed to having the Government in some form going and doing them ourselves?

In other words, here you have got a duty of confidentiality to your client which is at issue here. You may find things that would be of general interest to the SBA, to the taxpayer, and yet you are prohibited from coming forth with that evidence. Is there not—let me ask it more openly—is there a conflict here that would make it better for the system, if independent auditors were not performing this function and the Government itself was?

Mr. JENKINS. No, I do not believe there is a conflict. This is the way that audits have been performed for all companies forever, really. The SEC, with respect to public companies, has looked into this. There is explicit guidance with respect to it. It is really not a problem.

Even if we were employed or engaged by the SBA to do this audit, unless it was in the form of a special purpose report—for example, if as you have suggested, Mr. Chairman, the Inspector General employed independent auditors to do this special study that you have suggested, if we were employed to do a special study, we certainly could report on what we did and what we found. But if we were engaged by the SBA to do a Generally Accepted Auditing Standards audit, the results would be the same.

We need to go beyond that and get into the Government auditing standards arena to provide us with the opening so that we can be more helpful.

Senator LIEBERMAN. So you do not feel from a professional point of view that what is being asked of you in these cases is essentially to serve two masters? I mean, who are you working for when you are retained in one of these? For the SBIC? Or the for the Government, for the SBA?

Mr. **Jenkins**. We are engaged by the SBIC to report generally to the public on general purpose financial statements. And our audit report is available to whomever wants to use it. It is not designed specifically to answer the needs of the SBA alone. Nor is there any intention that it would satisfy the oversight responsibilities that the SBA has with respect to SBICs.

Senator **Lieberman**. So that you would say that although you are being paid by the SBIC, that your ultimate responsibility is not to the SBIC?

Mr. **Jenkins**. No, our responsibility is to the public.

Senator **Lieberman**. To the public as expressed through the professional standards of your profession?

Mr. **Jenkins**. That is correct.

Senator **Lieberman**. Thank you.

The **Chairman**. Senator Kasten.

STATEMENT OF HON. ROBERT W. KASTEN, Jr., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator **Kasten**. Mr. Chairman, I have no questions. Except I just would like to make a brief statement. I think these hearings that you had on the SBICs are important. And I think in the process of working through River Capital and some of these other kinds of problems, we have got to deal with the problems but also recognize that, overall, the SBICs are important. They are doing a lot of good. We are seeing growing entrepreneurs working within the structures of the SBICs.

What we have got to do is to deal with these problems but keep the overall program, in my view at least, keep the overall program growing and continuing to be successful. And I think that these hearings are pinpointing on some of the problems. We have also got to recognize some of the real pluses that this program has given to us.

Thank you, Mr. Chairman.

The **Chairman**. Mr. Jenkins, before we conclude this hearing, let me say that the American Institute of CPA's audit guide in this case, I think, you have followed. And I think GAO essentially validates that. But everybody here seems to agree now that both that guide and maybe the generally accepted accounting procedures are not adequate to protect the Government and the taxpayers in this particular instance.

We now know that the method of valuing portfolios is seriously inadequate. Would you agree with that?

Mr. **Jenkins**. Well, I think the oversight by either the SBA or by the independent auditors does not give the degree of assurance with respect to the valuations that the SBA would like to have.

The **Chairman**. And if it does not give that assurance, then, we are just wasting our money, are we not?

Mr. **Jenkins**. Well——

The **Chairman**. Or we are wasting the money of the SBIC that paid your fee?

Mr. **Jenkins**. No, because I think our audit performs other functions as well. We do provide a measure of control with respect to—and discipline—to the process by our responsibilities with respect to determining that the procedures followed by the board in making that valuation were reasonable.

We also carry out significant other audit steps with respect to investments and other aspects of the assets and liabilities of an SBA—of an SBIC. For example, as the GAO reported with respect to the investments themselves, seeing that investments have been made pursuant to the agreements with the investee, that the loan documents are adequate and have been followed with respect to the investments, observing the stock certificates have been issued in support of the investments and otherwise validating the—not the subsequent valuation of the investments but the mechanics and the cash outflow of the investment itself is certainly an important role for the auditor.

But what we would like to do is suggest that since we are in there doing the audit, that we perform—undertake, pursuant to Government auditing standards to do a little more and have the opportunity to report on compliance situations that we run across during our audit.

The CHAIRMAN. Mr. Jenkins, let me put it this way, because I think Arthur Andersen is a big company in this business. And I think these guides and the accounting procedures need major revision, when it comes to valuating portfolios, particularly in this case.

And when you consider the fact that Arthur Andersen did this audit on River Capital in December 1987, which indicated to anybody who looked at that audit, completely aside from your statement on how the values were reached, when you look at that, it says that this company is worth essentially $28.5 million. And 7 months later, this company is worth zero.

You would have to agree with me, would you not, that if you follow the guides and the generally accepted accounting procedures, that there is something seriously deficient about those procedures that would allow us, allow you, to reach the conclusion that it was worth $28 million, whereas in fact, at that very moment, it was probably worth zip?

Mr. JENKINS. Well, we would believe that our report in these circumstances that points out the uncertainty with respect to the valuation process and the valuations themselves and the estimates that are involved is important information for a user of the financial statements to have and that it is a very important red flag.

It is not designed to take us off the hook, so to speak, but is designed to inform a reader of the financial statements about the uncertainty of the investments. Without that report, the financial statements would stand showing, in River Capital's case, the approximately $28 million of investment without any commentary with respect to the uncertainty of that valuation.

So we would believe that our auditor's report in these circumstances is a very important part of the disclosure process.

The CHAIRMAN. We have a disagreement there, Mr. Jenkins. I just cannot buy that. I mean, I think that if that is—I just think that the Government—we did not pay for your audit. As I understand it, River Capital in 1987 paid Arthur Andersen $14,000 for that audit.

Mr. JENKINS. Yes, sir.

The **Chairman**. But the audit is being made for the benefit of the Government, as a guide to the Government as to the condition of that company. And when we get an audit in that shows a company is worth that amount of money, and then you have something in the back and say, this is based on—you know, these valuations may be wrong; and in this particular case, they turned out to be 100 percent wrong.

And what I am saying is, River Capital—the Government got nothing for the $14,000 that River Capital spent. And that is not to say that you did not comply with the letter of the investment guide and generally accepted accounting procedures, which brings me down to the bottom line that I started out with. And that is, these things have to be changed. Our Government has got to have better information than this on which to rely.

Mr. **Jenkins**. I could not agree with you more, Senator.

The **Chairman**. Now my next question is, as I say, you are a partner in Arthur Andersen, which puts you in a pretty high position. Arthur Andersen ought to be out in the forefront of trying to get these guidelines changed. Because I can tell you, whether they are changed or not, we are going to change them so far as the SBA is concerned.

We are not going to accept reports in the future. If nothing else comes out of these Committee hearings, I can tell you one thing that is coming out, and that is, we are not accepting, we are not accepting audits based on those two guides as determinative as to the condition of that company, because the valuations are virtually meaningless.

Now, I thought that Senator Lieberman hit on something that was very interesting a moment ago, and that is, what could be perceived as a conflict of interest. Now, how many years had Arthur Andersen done River Capital's audit?

Mr. **Jenkins**. Two years, 1986 and 1987 only.

The **Chairman**. Now as a, you know, as a lawyer, which I was a sort of at one time, when I first moved back to my little home town of 1,400 people and opened up my office, people who had seen me grow up a towheaded kid, would walk in and say are you not a sort of a lawyer; and they did not know how right they were because I was fresh out of law school.

But I know that I had clients that I wanted to satisfy, because I wanted their repeat business. I represented several corporations, and I had a few retainers. And I wanted to keep those retainers, and I wanted to keep my clients happy. And I assume that Arthur Andersen is not all that much different from a country lawyer in Charleston, AR. You want to keep your clients happy, too. And it was River Capital who was paying your fee, not the Government.

And while you say that the information was for the benefit of the public—highly laudatory. And yet it seems to me that there is room certainly for a conflict of interest because you are preparing this audit that you know is going to SBA and yet somebody else is paying your fee. And I would not think that you would have any great desire to insult them or to—and I am not really going to Arthur Andersen's integrity; I am just talking about human nature.

And so my question is maybe we ought to get—I think at one time, Pete—this is fairly informal at this stage—at one time the IG did all of the audits. Did they not? Or did they?

Mr. McClintock. I think there has always been a requirement to have a CPA.

The Chairman. Independent audits?

Mr. Jenkins. Well, let me respond to that, if I may, Mr. Chairman.

The Chairman. OK.

Mr. Jenkins. We have a confidentiality responsibility to our client. We also operate under our ethical rules as independent accountants, which means we are independent of our clients. And we have an ethical requirement to not be advocates for our clients.

In that regard, we are different from the law profession. Lawyers are to be advocates for their clients. When a CPA performs an audit in accordance with Generally Accepted Auditing Standards, he must be independent, and he must not be an advocate for his client. That imposes upon us a special duty. And the reason for that, unlike a lawyer, is that our reports are available to the public and are used by the public without the public having any direct interaction with either the auditor or the auditor's client. So there is that distinction there.

We are very conscious of our responsibilities. As I mentioned in my opening statement, we take them very seriously. And there is no doubt in my mind that we operate in an independent fashion and did so with respect to River Capital in particular.

So I really do not see that and, particularly in light of the other concerns that you have here, I really do not see that that is an issue. What we would like to do is see how we can help do more.

The Chairman. Mr. Jenkins, again, I thank you very much. You have been a cooperative witness, and we thank you for being with us this morning.

The Chairman. The Committee will recess.

[Thereupon, at 11:34 a.m., the hearing was recessed.]

SBA'S SMALL BUSINESS INVESTMENT COMPANIES PROGRAM

THURSDAY, AUGUST 2, 1990

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 9:35 a.m., in room SR-428A, Russell Senate Office Building, Hon. Dale Bumpers (Chairman of the Committee) presiding.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

The CHAIRMAN. The Committee will come to order. This morning the Committee will conduct its fourth hearing on problems facing the Small Business Investment Company Program. Testifying will be SBA Administrator, Susan Engeleiter, followed by representatives of two SBIC trade associations.

First, I want to thank Ms. Engeleiter for rearranging her schedule to be with us this morning. SBA has been conducting a national meeting of district directors in Houston, and she has absented herself from part of that meeting today to be here with us and we appreciate that very much.

I felt it was important to conclude this series of hearings before the August recess. We will probably hold one more hearing this fall to examine the final results of the Inspector General's and the Investment Division's ongoing examinations of SBIC licensees.

I only want to preface this morning's proceedings with two observations. First, as I am sure Ms. Engeleiter and the industry will remind us, SBIC's have been probably the salvation of the entire Small Business Administration, despite their recently encountered difficulties. In 1985, Senator Weicker, who was then our Chairman, and I sat through 3 days of hearings trying to determine the real merits of small business programs in light of President Reagan and David Stockman's all out effort to sink the Agency.

Those were difficult days, and some of the most impressive testimony we heard was from SBIC's borrowers. We found that 10 companies, including Cray Research, Federal Express, Nike, Digital Switch, and others, had in 1985 paid almost $200 million in Federal income taxes in 1984, and had over 53,000 employees. The return on these companies alone justified the entire cost of all SBA programs. And there is probably not another Government program anywhere which has had such stellar successes as the SBIC Program. So, we are not unmindful of the successes of this program.

Nonetheless, we cannot turn a blind eye to the alarming increase of SBIC failures in the last 4 or 5 years.

Second, we did not convene these hearings to make political points or get publicity or to make life difficult for SBA, the SBIC owners, or their representatives. A number of people have written me to say that they had applications in for SBIC licenses which have been caught in the recent administrative moratorium on licensing. I hope those who were caught in the moratorium will not despair and that they can be licensed shortly.

In any event, I hope that whatever hardships have resulted will soon be replaced by a better managed and more effective SBIC Program for all of us.

And finally, Ms. Engeleiter has just recently taken rather forceful action to deal with this problem, and I commend her for that. She called me some weeks ago to let me know of some major changes in personnel, and the purpose this morning is largely to let her tell the Committee the progress the Agency has made in getting this program on a sounder footing.

I look forward to the witnesses' testimony and the opportunity to have a meaningful dialogue about improvements that can be made in this SBIC Program.

Ms. Engeleiter, thank you again for being with us this morning at a considerable personal sacrifice to you. We thank you.

[The prepared statements of Senators Dixon and Grassley follow:]

STATEMENT BY SENATOR ALAN J. DIXON
BEFORE THE COMMITTEE ON SMALL BUSINESS
ON PROBLEMS IN THE
SMALL BUSINESS INVESTMENT COMPANIES INDUSTRY
AUGUST 2, 1990

MR. CHAIRMAN, OVER THE PAST SEVERAL MONTHS, THIS COMMITTEE HAS HELD A SERIES OF HEARINGS FOCUSING ON THE SERIOUS PROBLEMS CONFRONTING THE SMALL BUSINESS INVESTMENT COMPANIES (SBICs) INDUSTRY. THESE HEARINGS HAVE REVEALED AN ALARMING INCREASE IN THE FAILURES OF SBICs IN RECENT YEARS. THERE ARE CURRENTLY 170 SBICs IN LIQUIDATION -- NEARLY THIRTY PERCENT OF THE ENTIRE INDUSTRY. IN ADDITION, THE FEDERAL GOVERNMENT IS FACING THE POTENTIAL EXPOSURE OF OVER $560 MILLION DUE TO THE LOSSES FROM SBIC DEFAULTS.

A THIRTY PERCENT FAILURE RATE IS SYMPTOMATIC OF A PROCESS THAT IS OUT OF CONTROL. THE IMPORTANT QUESTION IS HOW DO WE REGAIN CONTROL? WE MUST EXAMINE THE MECHANISMS THAT CAUSED THE DEMISE OF SBICs AND THE SYSTEMIC PROBLEMS THAT PLAGUE THE SMALL BUSINESS ADMINISTRATION (SBA).

I WAS PLEASED TO SEE THAT ADMINISTRATOR ENGELEITER TOOK THE IMPORTANT STEP TO PLACE A 90-DAY MORATORIUM ON APPROVING NEW SBIC LICENSES. THIS ACTION SHOULD ENABLE THE SBA TO CONDUCT A CAREFUL REVIEW OF ITS REGULATORY PROCEDURES, ACCOUNTING PRACTICES, AND LIQUIDATION PROCESSES.

I FIRMLY SUPPORT THE SBIC CONCEPT OF PROVIDING FINANCING OF LAST RESORT TO MODERATE AND HIGH RISK BUSINESS VENTURES. OVERWHELMING SUCCESSES SUCH AS NIKE, FEDERAL EXPRESS, AND APPLE COMPUTERS ATTEST TO THE VALIDITY OF THIS CONCEPT. UNFORTUNATELY, IT APPEARS THAT THESE SUCCESSES ARE THE EXCEPTION AND NOT THE RULE. DURING THE PAST FEW YEARS, MANY SBICs HAVE DEMONSTRATED THE BEWILDERING TENDENCY TO BACK MORE LOSERS THAN WINNERS. THE GOAL MUST BE TO PROVIDE THE MOST SUCCESSFUL BUSINESS VENTURES WITH THE CAPITAL AVAILABLE. TO ACCOMPLISH THIS GOAL, THE SBA MUST TAKE A MORE PROACTIVE ROLE IN ESTABLISHING SOLID PRACTICES AND PROCEDURES FOR THE SBICs SO THAT A BETTER INVESTMENT SELECTION PROCESS IS GUARANTEED. EVERY INVESTMENT CANNOT BE EXPECTED TO SUCCEED, BUT ONLY THROUGH MORE PRUDENT SELECTION OF INVESTMENT OPPORTUNITIES CAN THE CONTINUANCE OF SMALL BUSINESS INVESTMENT PROGRAMS BE ENSURED.

SMALL BUSINESS OWNERS ARE FACING AN ENVIRONMENT IN WHICH NEW CAPITAL IS DRYING UP AND EXISTING CREDIT LINES ARE BEING REDUCED OR CALLED DUE. LOSSES RESULTING FROM SBIC DEFAULTS ARE STEALING AWAY THE MONEY OUR WEAKENING ECONOMY SO DESPERATELY NEEDS. THE SBIC PROGRAM MUST BE MADE MORE EFFICIENT AND EFFECTIVE SO THAT SMALL BUSINESSES HAVE ACCESS TO THIS IMPORTANT SOURCE OF VENTURE CAPITAL.

I COMMEND THE CHAIRMAN FOR HOLDING THIS SERIES OF HEARINGS ON PROBLEMS IN THE SBIC PROGRAM, AND I LOOK FORWARD TO ADMINISTRATOR ENGELEITER'S DISCUSSION OF SBA's EFFORTS TO CORRECT THE MAJOR WEAKNESSES IN THE SBIC PROGRAM.

STATEMENT OF SENATOR CHARLES E. GRASSLEY
SMALL BUSINESS COMMITTEE HEARING
SMALL BUSINESS INVESTMENT COMPANIES
AUGUST 2, 1990

Mr. Chairman:

Thank you for holding this fourth hearing to give the Small Business Committee another opportunity to examine SBA's Small Business Investment Companies (SBIC) Program.

I am concerned about the well-being of the SBIC program. As I have stated in the three previous hearings, I believe that even the appearance of misuse of taxpayer dollars needs to be eliminated. Historically, the SBIC program has been a valuable asset in providing the necessary venture capital for many high-risk small businesses. It is my hope that the efforts of this Committee will aid in remedying the weaknesses of this program. Cooperation between Congress and the Administration is essential if we are to truly assist our nation's small business entrepreneurs.

I want to welcome SBA Administrator Susan Engeleiter to the hearing this morning. I believe that Administrator Engeleiter has taken positive steps in correcting the short-comings in the SBIC program. I know she has made resolving the problems with the SBIC program a priority project for SBA. Her efforts include forming a new management review team, commissioning outside contractors for review of the SBIC program, placing a 90-day moratorium on approving licenses for new SBICs, and taking numerous steps to eliminate the appearance and existence of wrong-doing with SBA funds.

I know the Administrator is serious about restoring the SBIC program to its full capabilities. Thank you for your efforts and continued hard work on this problem. I appreciate your testifying before this Committee. I look forward to hearing your insights and evaluation of the problems this program has experienced; the results of the steps you have taken to repair and improve the program; and your recommendations and further goals for the SBIC program.

I also want to thank Mr. Ewing and Mr. Fletcher for appearing before us today. I look forward to hearing their testimony on this issue, as well.

STATEMENT OF HON. SUSAN S. ENGELEITER, ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC, ACCOMPANIED BY MITCHELL F. CRUSTO, ASSOCIATE DEPUTY ADMINISTRATOR FOR FINANCE, INVESTMENT AND PROCUREMENT; SALLY NAREY, GENERAL COUNSEL; AND BERNARD KULIK, ASSOCIATE ADMINISTRATOR FOR INVESTMENT, SBA

Ms. ENGELEITER. Thank you very much, Mr. Chairman. Mr. Chairman, it is a pleasure to testify before you today as the Administrator of the U.S. Small Business Administration. I am accompanied today by Mr. Mitchell Crusto, who is the Associate Deputy Administrator for Finance, Investment and Procurement; Ms. Sally Narey, who is our General Counsel; and Mr. Bernard Kulik, Associate Administrator for Investment.

You have asked me to address the Small Business Investment Company Program. It has been a number of years since either oversight committees or previous SBA Administrators have thoroughly reviewed the program. And I appreciate the attention you and the committee are giving to its improvement. I consider us allies in correcting the problems that have developed in the program.

Clearly, as you have indicated, Mr. Chairman, the SBIC Program was created with the best of intentions. Its mission is to help America's small businesses obtain start-up and growth capital they usually cannot obtain from banks and other financial institutions. SBIC's are fulfilling that mission, and the need for the program remains very strong.

Unfortunately, however, the program does have a number of problems, some of which stem from the inherent risks that are involved in investing in small businesses. I believe that it is important for Congress to determine what level of risk it is prepared to accept in order to achieve the program's mission.

Problems have also resulted from the financial structure of the program which encourages thinly capitalized SBIC's to leverage up by borrowing Government funds to make equity investments in small businesses. Equity investments, like other types of stock investments, seldom offer immediate cash-flow for the SBIC's. And this can result in an eventual cash-flow crunch when the SBIC's attempt to repay loans and meet operating expenses. The cash-flow need may ultimately conflict with pure equity financing of small businesses.

At the same time, spotty Government oversight and supervision of the SBIC Program led to ineffective monitoring and regulation of the industry. This was due in part to cutbacks in staffing, going many years back, and in part to a longstanding separation of program functions within the Agency. No one office at the Small Business Administration has had full oversight responsibility over the program.

In my written testimony, Mr. Chairman, I described how these problems came to my attention last year and the steps that I have taken to investigate and remedy them. I would like, however, to summarize our findings and the actions that we have taken.

As a result of our review of program operations, it has been clear that there was no clear picture of the financial status of the industry. SBIC oversight was unnecessarily split between Agency units. Program regulations did not effectively prevent abuses and deviations from the basic purpose of the program. There was insufficient staff for necessary oversight, and there was undue risk of loss to the Government without sufficient financial safeguards.

We are now strengthening program oversight and internal controls, re-evaluating our regulatory policies, and assessing our staffing needs. I would like to describe to you what we have done thus far.

First, we have made several management changes in the program. We have installed as Associate Administrator for Investment one of our most seasoned career professionals, Mr. Bernard Kulik. We have also identified the need for additional staffing, and have added five new positions to our Investment Division.

In addition, we are conducting a review to determine a level of resources and staffing sufficient to cover improved analysis and oversight, on-site reviews, and more thorough evaluation reviews.

Second, as you indicated, Mr. Chairman, we have imposed a 90-day moratorium on issuing new SBIC licenses. Although we are continuing to accept and process applications, no licenses will be issued until we have reviewed current requirements and procedures. This was suggested by you, Mr. Chairman, during recent hearings, and we agree that the moratorium will assist our review of program management and operations.

Third, we are preparing a number of regulatory changes, which will need OMB clearance before publication. One change, which will be published shortly for comment, will adopt Government accounting standards for SBIC audits by independent public accountants as recommended by the General Accounting Office. As a result, we will obtain additional separate reports from the SBIC's independent public accountants covering the SBIC's internal controls and regulatory compliance. This should materially assist our oversight role.

A second regulatory change now in review, contains 15 proposed revisions covering such areas as limitations on Government debt subordination, requirements for financial statements from small business concerns, limitations on leveraged buyouts of large businesses using SBIC funds, and limitations on the placement of idle funds.

Other proposals are in various stages of preparation and include clarification of the portfolio review requirements for independent public accountants, revision of the size standards, development of a policy on the effect of delinquent preferred stock dividends on SBA leverage requests, and definitions of social or economic disadvantaged for specialized SBIC's.

Fourth, as required by statute, we have issued the call for SBIC funding to be completed in September but have requested that SBIC's provide additional information for portfolio evaluation. For the funding completed at the end of June, also required by statute, SBICs had requested $53 million in additional funding. After a very careful review of the financial material filed in support of these requests, SBA scrubbed the funding request down to $12.2 million.

Fifth, with respect to valuation problems, the Inspector General has completed phase 1 of his special study of SBIC valuation and reported the findings of this study at a previous hearing. We have received the draft report which details the valuation practices and problems of five specific SBIC's. One appears to have no portfolio valuation problems. A second will be carefully watched because of its financial weaknesses and that of its parent bank. A third, which has some questionable valuations but is not capitally impaired will be asked to supply specific valuation information. A fourth will be ordered to cure its probable impairment or face liquidation. And the fifth will be considered for liquidation based, in part, on the evidence from the IG's report.

Sixth, phase 2 of the IG study, which involved on-site examinations of certain SBIC's, is now under way in coordination with the Investment Division. This will be completed shortly and evaluated for appropriate action.

Seventh, at the request of the Investment Division, an outside contractor has completed evaluation study of a related group of SBIC's. A draft of that study was delivered to the Agency this week and is being reviewed for appropriate action.

Eighth, for those SBIC's not covered by these on-site visits, the Investment Division will soon require each SBIC to respond to a one-time Financial and Regulatory Analysis Disclosure Statement. The statement will give us current details of the status of each SBIC, its portfolio, and its accounting practices, as of June 30, 1990. SBIC's will be required to compete and return the report within 30 days.

We believe these steps will enable us to implement on-site review capability within the limits of our available resources to supplement the examinations performed by the Inspector General.

In addition, the IG is concentrating on the responsibilities of the SBIC's independent public accountants. An expert in audit quality control has recently joined the IG staff, and as a result, we believe appropriate action will be forthcoming shortly.

In recent hearings, Mr. Chairman, you have suggested an immediate on-site examination of each SBIC. We agree that these reviews would be very valuable in protecting the $1.2 billion investment the Government has outstanding in the SBIC Program and have calculated the cost of such an examination to be approximately $7 million to $10 million.

Finally, we are enlisting the services of the Private Sector Council, a nonprofit organization of volunteers from the highest levels of the private sector to help us review basic questions concerning the program. Its first task is review of our licensing requirements. We hope to have this review completed in due course and look forward to their recommendation.

Our basic purpose in taking these steps is to enhance the success of the program. Our goals are to improve the Agency's ability to detect problems early, develop solutions in a timely manner, and substantially improve the efficiency of operating procedures.

Now, let me now finally turn to the SBIC liquidation process, which we have also reviewed, and summarize our findings there. The backlog of SBIC cases in liquidation has grown to over 170, owing the Government over $500 million.

Second, we found that there were only five staff members managing these cases. There were substantial amounts of idle cash in a number of SBIC's in liquidation, and some receiverships that were as old as 20 years old. There were insufficient controls in place to handle the liquidation. Senior management was not involved in liquidation decisions involving millions of dollars, and when SBIC's were transferred in liquidation, their assets were valued according to value set by SBIC management rather than attempting to determine their current value for the purpose of assessing potential recovery or booking current loss.

We also found staffing levels in the SBIC liquidation and portfolio management section over the last decade to be woefully inadequate. Due to budget constraints, staffing in this area failed to keep pace with increased activity, both in terms of numbers and complexity of cases. From 1980 to 1989, SBA averaged two to three full-time employees in the SBIC liquidation staff with additional assistance from six outside contractors on receivership cases.

In 1980, the liquidation portfolio was at $100 million, but by 1989 had grown to almost $500 million. Despite this growth, there were only five full-time employees in the liquidation area in 1989. Recognizing this problem, I submitted a request for additional staffing from the Office of Management and Budget. As a result, seven new full-time employees will be added to this function. Five are already on board.

Even so, industry standards are $10 million per portfolio liquidator. If this standard were applied to our $500 million portfolio, we would need a staff of 50. In addition, many of the salaries offered for comparable financial and specialist positions at other agencies, such as RTC and FDIC, are at least one grade level higher than those at the Small Business Administration. Obviously, this makes retention and recruitment very difficult. Nevertheless, we believe we are continuing to make a great deal of progress despite an overworked and, frankly, underpaid staff.

As you know, there has been an upturn in SBIC defaults since 1985. The average of SBIC's annually placed in liquidation has doubled from 13 to 26 over the past 5 years. Perhaps even more disturbing are the size and complexity of those SBIC's going into liquidation. In fact, the two largest liquidations in the history of the program occurred this last year.

There are many factors that seem to have caused this trend, including the bursting of the high-technology investment bubble of the late 1970's and early 1980's; the 1987 stock market collapse, which depressed stock prices and seriously limited opportunities for taking young start-up companies public at favorable stock prices; and greater competition from other capital sources during the 1970's and 1980's for fewer good deals with substantially higher returns.

In order to better manage the liquidation process, we have taken the following steps. We have recovered $14.3 million in closing out 24 SBIC liquidation cases and have written off $24 million as uncollectible. Twenty additional cases totaling $76 million are targeted for resolution by the end of the calendar year.

Second, we have identified cases in which SBIC's in receivership have excess cash in their accounts and have moved where appropriate to have the excess cash transferred to the SBA. We are actively pursuing these claims through the courts and in one case have collected over $1 million in cash.

We have completed liquidation plans for five SBIC's that have not complied with existing settlement agreements, implemented revised procedures to independently value the assets of SBIC's that are in liquidation and the assets acquired from failed SBIC's that voluntarily assigned their assets to SBA.

Revised internal accounting procedures ensure that losses anticipated and liquidation proceedings are recognized immediately upon transfer to SBA, and we have established new procedures to involve senior management in the liquidation process and strengthen guidelines for approval of expenditures relating to the liquidation of acquired assets.

We have developed and begun implementing new operating procedures for SBIC's in receivership, and have also restructured the Office of SBIC Liquidation.

And finally, we have updated our Liquidation Procedures Manual, with a final draft scheduled for September 30.

In summary, Mr. Chairman and Members, the purpose of all the actions taken thus far is to make the SBIC Program more effective and efficient while continuing active Government encouragement of venture capital for small businesses. We believe that these numerous remedial steps will limit the Agency's vulnerability to financial losses, and provide more efficient and timely identification and resolution of problems in the program.

I would like to thank you, Mr. Chairman, and Members of the Committee, for your strong interest in the health of the SBIC Program, and your invaluable assistance in identifying some of the program's problems. As we continue to take steps necessary to correct program deficiencies, some of which may necessitate legislative changes, we look forward to your continued support. Working together, I believe that we will be able to protect the Government's interest while ensuring that small business investment companies remain a valuable source of capital for American small businesses.

I thank you, and I would be more than happy to answer questions, as would my colleagues.

[The prepared statement of Ms. Engeleiter follows:]

TESTIMONY OF
SUSAN S. ENGELEITER
ADMINISTRATOR
U.S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
SENATE COMMITTEE ON SMALL BUSINESS

AUGUST 2, 1990

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE, IT IS A PLEASURE TO TESTIFY BEFORE YOU TODAY AS ADMINISTRATOR OF THE U.S. SMALL BUSINESS ADMINISTRATION (SBA). I AM ACCOMPANIED BY MR. MITCHELL F. CRUSTO, ASSOCIATE DEPUTY ADMINISTRATOR FOR FINANCE, INVESTMENT AND PROCUREMENT; MS. SALLY NAREY, THE GENERAL COUNSEL; AND MR. BERNARD KULIK, ASSOCIATE ADMINISTRATOR FOR INVESTMENT.

I. OVERVIEW

SINCE TAKING UP MY OFFICIAL DUTIES AT THE SBA ON APRIL 20 OF LAST YEAR, I HAVE HAD THE OPPORTUNITY TO BECOME INCREASINGLY AWARE OF THE IMPORTANT AND INNOVATIVE ROLE SBA'S PROGRAMS PLAY IN ASSISTING SMALL BUSINESSES TO START UP, EXPAND AND SURVIVE IN AN INCREASINGLY COMPETITIVE FINANCIAL ENVIRONMENT. SBA'S PROGRAMS ARE ESPECIALLY NEEDED AT THIS TIME, WHEN SMALL BUSINESSES ARE FACED WITH A MORE INTENSE NEED FOR ACCESS TO CAPITAL. IT IS THE AVAILABILITY OF CAPITAL THAT CAN MAKE THE DIFFERENCE BETWEEN SUCCESS AND FAILURE FOR SMALL BUSINESSES AND THE PEOPLE THEY EMPLOY.

YOU HAVE ASKED ME TO ADDRESS ONE OF THESE PROGRAMS -- THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM. MR. CHAIRMAN, I APPRECIATE THE ATTENTION YOU AND THE COMMITTEE ARE GIVING TO THE

IMPROVEMENTS THAT MUST BE MADE IN THE MANAGEMENT OF THE SBIC PROGRAM. IT HAS BEEN A NUMBER OF YEARS SINCE EITHER OF THE OVERSIGHT COMMITTEES OR PREVIOUS SBA ADMINISTRATORS HAVE THOROUGHLY REVIEWED THIS PROGRAM. I CONSIDER US ALLIES IN CORRECTING THE PROBLEMS THAT HAVE DEVELOPED.

I WOULD LIKE TO BEGIN BY MAKING SOME OVERALL COMMENTS ON THE SBIC PROGRAM. CLEARLY IT IS A PROGRAM FILLED WITH GOOD INTENTIONS. THE MISSION OF SBICS IS TO HELP AMERICA'S SMALL BUSINESSES OBTAIN START-UP AND GROWTH CAPITAL THEY USUALLY CANNOT OBTAIN FROM BANKS AND OTHER FINANCIAL INSTITUTIONS. SBICS ARE FULFILLING THAT MISSION AND THE NEED FOR THE PROGRAM REMAINS STRONG.

UNFORTUNATELY, HOWEVER, THE PROGRAM HAS PROBLEMS. THESE PROBLEMS GO TO THE FUNDAMENTAL NATURE OF THE PROGRAM AND THE GOVERNMENT'S REGULATION OF THE SBIC INDUSTRY.

FIRST, PROBLEMS STEM FROM THE INHERENT RISK INVOLVED IN INVESTING IN SMALL BUSINESSES. THIS IS A HIGH RISK PROGRAM, AND SIZABLE DOLLARS ARE AT STAKE. CONGRESS MUST DETERMINE WHAT LEVEL OF RISK IT IS PREPARED TO ACCEPT TO ACHIEVE THE PROGRAM'S MISSION.

SECOND, PROBLEMS RESULT FROM THE PRESENT FINANCIAL STRUCTURE OF THE PROGRAM. THE PROGRAM MAINLY ENCOURAGES THINLY CAPITALIZED SBICS TO "LEVERAGE UP" BY BORROWING GOVERNMENT FUNDS TO MAKE EQUITY INVESTMENTS IN SMALL BUSINESSES. THE EQUITY INVESTMENTS, LIKE OTHER TYPES OF STOCK, SELDOM OFFER IMMEDIATE CASH FLOW FOR THE SBIC. THIS CAN RESULT IN AN EVENTUAL CASH FLOW CRUNCH. SBICS MUST GENERATE ENOUGH IMMEDIATE INCOME TO MAKE INTEREST PAYMENTS ON THEIR GOVERNMENT "LOANS" AND TO COVER OVERHEAD AND OPERATING EXPENSES. THIS CASH FLOW NEED CAN CONFLICT WITH PURE EQUITY FINANCING OF SMALL BUSINESSES.

THIRD, PROBLEMS RESULT FROM SPOTTY GOVERNMENT OVERSIGHT AND SUPERVISION OF THE PROGRAM. I BELIEVE THAT OUR PRESENT REGULATORY AND SUPERVISORY FRAMEWORK IS INEFFECTIVE IN MONITORING AND REGULATING THE SBIC INDUSTRY. THIS PROBLEM IS IN PART DUE TO CUTBACKS IN STAFFING GOING BACK MANY YEARS, AND IN PART TO A LONGSTANDING SEPARATION OF PROGRAM FUNCTIONS. LICENSING, LEVERAGING AND PROGRAMMATIC REGULATION OF ACTIVE SBICS ARE ASSIGNED TO THE INVESTMENT DIVISION, WHILE REGULATORY AUDITS/EXAMINATIONS ARE HANDLED BY THE INSPECTOR GENERAL, AND THE LIQUIDATION OF DEFUNCT SBICS IS HANDLED BY THE OFFICE OF PORTFOLIO MANAGEMENT. THUS, NO ONE OFFICE HAS FULL OVERSIGHT OF THE PROGRAM.

II. BACKGROUND

TO UNDERSTAND THE ISSUES INVOLVED WITH SBICS AND THEIR REGULATION, IT IS IMPORTANT TO BE AWARE OF THE PROGRAM'S BACKGROUND. THE SBIC PROGRAM, CREATED BY THE SMALL BUSINESS INVESTMENT ACT OF 1958, STIMULATES AND SUPPLEMENTS THE FLOW OF PRIVATE CAPITAL TO BOTH NEWLY FORMED AND EXISTING SMALL BUSINESSES. THESE BUSINESSES USE THE CAPITAL TO FINANCE OPERATIONS, GROWTH, EXPANSION AND MODERNIZATION. IN ADDITION TO REGULAR SBICS, THERE ARE SPECIALIZED SBICS, OR "MESBICS", STATUTORILY DEDICATED TO ASSISTING SMALL BUSINESSES OWNED BY SOCIALLY OR ECONOMICALLY DISADVANTAGED AMERICANS, MAINLY MEMBERS OF MINORITY GROUPS.

AS YOU ARE AWARE, THE CONCEPT BEHIND SBICS IS TO UTILIZE THE EXPERTISE OF PRIVATE SECTOR VENTURE CAPITALISTS, ENCOURAGE THEM TO RAISE PRIVATE CAPITAL TO INVEST IN SMALL BUSINESS, AND PROVIDE A VEHICLE TO RAISE ADDITIONAL FUNDS. THE FUNDING MECHANISM GENERALLY INVOLVES SBA GUARANTEES OF SBIC DEBENTURES ISSUED TO THE INVESTING PUBLIC.

I REGARD SBICS AND THE SBA AS A POSITIVE PRIVATE-PUBLIC PARTNERSHIP TO ASSIST SMALL AND MINORITY BUSINESSES. THE SBIC PROGRAM HAS PRODUCED ALMOST $9 BILLION IN PUBLIC AND PRIVATE CAPITAL INVESTMENTS IN AMERICA'S SMALL BUSINESSES. THE SBA HAS PROVIDED ABOUT $3 BILLION OF THAT TOTAL. MANY MAJOR FIRMS, INCLUDING SOME THAT HAVE BECOME HOUSEHOLD NAMES, HAVE BENEFITTED FROM EARLY INFUSIONS OF SBIC FINANCING, INCLUDING APPLE COMPUTER, FEDERAL EXPRESS, MIDWAY AIRLINES, CRAY RESEARCH, INTEL, PANDICK PRESS, ROLM CORPORATION, TELEDYNE AND FINANCIAL NEWS NETWORK.

TAXPAYERS HAVE ALSO BENEFITTED. DURING FISCAL YEAR 1989, THE ACTIVE SBICS PAID $58 MILLION IN INCOME TAXES. SMALL BUSINESSES FINANCED BY SBICS PAY MANY TIMES MORE IN FEDERAL, STATE AND LOCAL TAXES.

SBICS ALREADY ARE GOVERNED BY A NUMBER OF REQUIREMENTS MEANT TO ENSURE THEIR INTEGRITY. THE MINIMUM PRIVATE CAPITAL NEEDED FOR LICENSING AN SBIC IS $1 MILLION. EACH SBIC MUST HAVE A MANAGER WHO HAS AT LEAST FIVE YEARS OF SUCCESSFUL BUSINESS INVESTING OR COMMERCIAL LENDING EXPERIENCE.

AN APPLICANT MUST SUBMIT TO SBA AN ACCEPTABLE BUSINESS PLAN SHOWING THE NEED FOR THE PROPOSED SBIC AND THE WAY IN WHICH THE APPLICANT WILL MEET THAT NEED IN A MANNER CONSISTENT WITH THE PROGRAM'S PURPOSE AND REGULATIONS. APPLICANTS MUST PROVIDE INCOME AND EXPENSE PROJECTIONS THAT APPEAR ACHIEVABLE FOR THE AMOUNT AND TYPE OF SMALL BUSINESS INVESTMENTS CONTEMPLATED, AND THEY MUST DEMONSTRATE A LIKELIHOOD OF FINANCIALLY SUCCESSFUL OPERATIONS. ONCE LICENSED, AN SBIC IS SUBJECT TO PROGRAM REGULATIONS WHICH PROHIBIT THE FOLLOWING:

1) CONFLICTS OF INTEREST AND SELF-DEALING;
2) OVER-CONCENTRATION OF FINANCING IN ANY ONE SMALL BUSINESS;
3) FINANCING OF BUSINESSES THAT DO NOT QUALIFY AS SMALL. IN THE CASE OF A SPECIALIZED SBIC, SMALL CONCERNS MUST ALSO BE OWNED AND CONTROLLED BY A DISADVANTAGED PERSON;
4) CHARGING EXCESSIVE INTEREST AND FEES ON SMALL BUSINESS FINANCINGS;
5) ACQUIRING CONTROL OF A SMALL CONCERN EXCEPT WHERE NECESSARY TO PROTECT THE SBIC'S INVESTMENT, AND WITH REQUIRED SBA APPROVAL; AND

6) FINANCING RENTAL INCOME PROPERTIES, SPECULATIVE STOCK INVESTING, OR OTHER ACTIVITIES NOT CONSISTENT WITH STATUTE AND REGULATIONS.

LICENSEES ARE SUBJECT TO BIENNIAL COMPLIANCE EXAMINATIONS PERFORMED BY SBA'S INSPECTOR GENERAL (IG) AND MUST SUBMIT ANNUAL AUDITED FINANCIAL REPORTS TO THE SBA.

III. PROBLEMS AND ACTIONS

HOWEVER, IT IS NOW CLEAR THAT THESE REQUIREMENTS HAVE NOT DONE THE JOB. SHORTLY AFTER BECOMING ADMINISTRATOR, I RECEIVED A REPORT FROM THE OFFICE OF THE INSPECTOR GENERAL ON AN SBIC EXAMINATION WHICH THE IG HAD STARTED IN EARLY 1988. THE REPORT RAISED QUESTIONS ABOUT THE LIQUIDATION OF AN SBIC, ROYAL BUSINESS FUNDS CORPORATION. UPON RECEIVING THE REPORT ON AUGUST 18, 1989, I ESTABLISHED A SENIOR MANAGEMENT TASK FORCE HEADED BY DEPUTY ADMINISTRATOR KAY BULOW TO REVIEW THE PROBLEMS IDENTIFIED BY THE IG.

THIS INITIAL STUDY HAS SET IN MOTION ADDITIONAL REVIEWS AND FINDINGS THAT HAVE FOCUSED ON TWO BROAD AREAS: OPERATION OF THE SBIC PROGRAM AND SBIC LIQUIDATION. FIRST, I WOULD LIKE TO

DESCRIBE THE ACTIONS WE ARE TAKING IN REGARD TO PROGRAM OPERATIONS.

AS RESULT OF OUR REVIEWS, IT HAS BECOME CLEAR THAT:

1) WE DID NOT HAVE A CLEAR PICTURE OF THE CURRENT FINANCIAL STATUS OF THE INDUSTRY;
2) OUR SBIC OVERSIGHT WAS UNNECESSARILY SPLIT BETWEEN AGENCY UNITS;
3) OUR REGULATIONS DID NOT PREVENT ABUSES AND STRAYING FROM THE BASIC PURPOSE OF THE PROGRAM;
4) WE WERE UNDERSTAFFED FOR THE NEEDED OVERSIGHT JOB; AND
5) THERE WAS AN UNDUE RISK OF LOSS TO THE GOVERNMENT WITHOUT SUFFICIENT FINANCIAL SAFEGUARDS.

WE ARE NOW TAKING ACTIONS DESIGNED TO STRENGTHEN PROGRAM OVERSIGHT AND INTERNAL CONTROLS, REEVALUATING OUR REGULATORY POLICIES AND ASSESSING OUR STAFFING NEEDS.

1) WE HAVE MADE CHANGES IN THE MANAGEMENT OF THE PROGRAM. WE HAVE INSTALLED AS ASSOCIATE ADMINISTRATOR FOR INVESTMENT ONE OF OUR MOST SEASONED CAREER PROFESSIONALS, MR. BERNARD KULIK; WE HAVE ADDED FIVE

NEW POSITIONS TO THE INVESTMENT DIVISION; AND WE ARE CONDUCTING A REVIEW TO DETERMINE A LEVEL OF RESOURCES AND STAFFING SUFFICIENT TO COVER IMPROVED ANALYSIS AND OVERSIGHT, ON-SITE REVIEWS, AND MORE THOROUGH EVALUATION REVIEWS.

HISTORICALLY, OUR RESOURCES HAVE DIMINISHED AS OUR RESPONSIBILITIES HAVE GROWN. STAFF RESOURCES HAVE BEEN CUT BY 66 PERCENT, WHILE GOVERNMENT RISK OF LOSS HAS INCREASED 382 PERCENT. IN 1970, WHEN THE SBIC PROGRAM WAS MUCH MORE SIMPLE AND UNSOPHISTICATED IN TERMS OF STATUTORY REQUIREMENTS AND THE AMOUNT OF GOVERNMENT LEVERAGE, THE INVESTMENT DIVISION HAD A STAFF OF 84 TO REGULATE A PROGRAM THAT INCLUDED 451 SBICS. THE CURRENT PROGRAM INCLUDES 389 ACTIVE SBICS (AND 39 ADDITIONAL PENDING LICENSE APPLICATIONS), AND THE DIVISION'S STAFF NUMBERS JUST 29, NOT INCLUDING THE FIVE NEW POSITIONS JUST RECENTLY ADDED. FURTHERMORE, IN 1970, THE TOTAL SBA EXPOSURE IN OPERATING SBICS WAS AN ESTIMATED $314 MILLION, WHILE IN 1990, THE TOTAL SBA EXPOSURE IN OPERATING SBICS IS APPROXIMATELY $1.2 BILLION, OR FOUR TIMES THE 1970 FIGURE. WE WILL BE WORKING WITH OMB TO ADDRESS THESE STAFFING CONCERNS.

2) WE HAVE IMPOSED A 90-DAY MORATORIUM ON ISSUING NEW SBIC LICENSES. ALTHOUGH WE ARE CONTINUING TO ACCEPT AND PROCESS APPLICATIONS, NO LICENSES WILL BE ISSUED UNTIL WE HAVE REVIEWED THE CURRENT REQUIREMENTS AND PROCEDURES. THIS WAS SUGGESTED BY YOU, SENATOR BUMPERS, DURING A NUMBER OF RECENT HEARINGS, AND WE AGREE THAT A MORATORIUM WOULD HELP AVOID ANY PROBLEMS THAT MIGHT BE FLAGGED IN OUR AGENCY'S REVIEW OF THE MANAGEMENT AND OPERATION OF THE PROGRAM.

3) WE ARE PREPARING TO ISSUE REGULATORY CHANGES. BECAUSE OF THE NUMBER OF PROPOSED CHANGES AND THEIR VARYING COMPLEXITY, THEY ARE BEING PREPARED AND WILL BE PUBLISHED FOR COMMENT SERIALLY. EACH OF THESE PROPOSALS WILL HAVE TO RECEIVE OMB CLEARANCE BEFORE PUBLICATION.

THE FIRST CHANGE IS TO ADOPT GOVERNMENT AUDITING STANDARDS FOR THE SBIC AUDITS BY INDEPENDENT PUBLIC ACCOUNTANTS, AS RECOMMENDED BY THE GOVERNMENT ACCOUNTING OFFICE. THAT REGULATION HAS BEEN DRAFTED AND WILL BE PUBLISHED FOR COMMENT SHORTLY. THE CHANGE WILL RESULT IN GETTING ADDITIONAL, SEPARATE REPORTS

FROM THE SBIC'S INDEPENDENT PUBLIC ACCOUNTANT COVERING THE SBIC'S INTERNAL CONTROLS AND ITS REGULATORY COMPLIANCE. THESE REPORTS SHOULD MATERIALLY ASSIST THE AGENCY IN ITS OVERSIGHT ROLE.

THE NEXT PACKAGE, CURRENTLY IN REVIEW, CONTAINS 15 PROPOSED REVISIONS COVERING AREAS SUCH AS LIMITATIONS ON GOVERNMENT DEBT SUBORDINATION, REQUIREMENTS FOR FINANCIAL STATEMENTS FROM SMALL BUSINESS CONCERNS, LIMITATIONS ON LEVERAGED BUY OUTS, AND LIMITATIONS ON THE PLACEMENT OF IDLE FUNDS. ADDITIONAL PROPOSALS, NOW IN VARIOUS STAGES OF PREPARATION, INCLUDE A CLARIFICATION OF THE PORTFOLIO REVIEW REQUIREMENTS FOR INDEPENDENT PUBLIC ACCOUNTANTS, A REVISION OF THE SIZE STANDARDS, A POLICY ON THE EFFECT OF DELINQUENT PREFERRED STOCK DIVIDENDS ON SBA LEVERAGE REQUESTS, AND A DEFINITION OF SOCIAL OR ECONOMIC DISADVANTAGE FOR SPECIALIZED SBICS.

4) AS REQUIRED BY STATUTE, WE HAVE ISSUED THE CALL FOR AN SBIC FUNDING TO BE COMPLETED IN SEPTEMBER. THESE FUNDINGS ARE OFFERED TO ALL SBICS BUT GRANTED ONLY TO THOSE IN GOOD STANDING. IN FACT, FOR THE FUNDING

COMPLETED AT THE END OF JUNE, SBICS REQUESTED $53 MILLION DOLLARS IN ADDITIONAL FUNDING. AFTER CAREFUL REVIEW OF THE FINANCIAL MATERIAL FILED IN SUPPORT OF THESE REQUESTS, SBA "SCRUBBED" THE FUNDING REQUEST DOWN TO $12.3 MILLION. AFTER REVIEWING THE FUNDING CRITERIA, WE ARE NOW REQUESTING THAT SBICS PROVIDE ADDITIONAL INFORMATION CONCERNING PORTFOLIO VALUATION FOR PARTICIPATION IN THE SEPTEMBER FUNDING.

5) WITH RESPECT TO VALUATION PROBLEMS, THE IG HAS COMPLETED PHASE I OF HIS SPECIAL STUDY OF SBIC EVALUATION AND REPORTED THE FINDINGS OF THIS STUDY AT A PREVIOUS HEARING. WE HAVE REVIEWED THE IG'S DRAFT REPORT WHICH DETAILS THE VALUATION PRACTICES AND PROBLEMS OF FIVE SBICS. ONE SBIC APPEARS TO HAVE NO PORTFOLIO VALUATION PROBLEMS. A SECOND SBIC WILL BE CAREFULLY WATCHED BECAUSE OF ITS FINANCIAL WEAKNESS AND THE FINANCIAL WEAKNESS OF ITS PARENT BANK. A THIRD SBIC, WHICH HAS SOME QUESTIONABLE VALUATIONS BUT IS NOT CAPITALLY IMPAIRED, STILL WILL BE ASKED TO SUPPLY SPECIFIC VALUATION INFORMATION. A FOURTH SBIC WILL BE ORDERED TO CURE ITS PROBABLE IMPAIRMENT OR FACE LIQUIDATION BASED ON EVIDENCE FROM THE IG REPORT OF A

49-PERCENT IMPAIRMENT SHOWN AT THE SBIC'S MID-FISCAL YEAR REPORT. A FIFTH SBIC WILL BE CONSIDERED FOR LIQUIDATION BASED IN PART ON THE EVIDENCE FROM THE IG REPORT OF AN UNREPORTED DEFAULT ON A DEBT THAT IS SUPERIOR TO SBA'S POSITION.

6) PHASE II OF THE IG STUDY INVOLVES "ON-SITE" EXAMINATION OF CERTAIN SBICS, IN COORDINATION WITH THE INVESTMENT DIVISION, AND IS NOW UNDERWAY. THIS WILL BE COMPLETED SHORTLY AND EVALUATED FOR APPROPRIATE ACTION BASED ON THE MATERIAL FOUND IN THESE VISITS.

7) IN ADDITION TO THE IG'S SPECIAL STUDY, AT THE REQUEST OF THE INVESTMENT DIVISION, AN OUTSIDE CONTRACTOR HAS COMPLETED A VALUATION STUDY OF A RELATED GROUP OF SBICS. A DRAFT REPORT OF THAT STUDY WAS DELIVERED THIS WEEK TO THE INVESTMENT DIVISION AND IS CURRENTLY BEING REVIEWED FOR APPROPRIATE ACTION.

8) FOR THE SBICS NOT COVERED BY THESE ON-SITE VISITS, THE INVESTMENT DIVISION WILL SHORTLY REQUIRE EACH SBIC TO RESPOND TO A ONE-TIME FINANCIAL AND REGULATORY ANALYSIS

DISCLOSURE STATEMENT WHICH WILL GIVE US CURRENT DETAILS OF THE STATUS OF EVERY SBIC, ITS PORTFOLIO, AND ACCOUNTING PRACTICES AS OF JUNE 30, 1990. THIS STATEMENT IS CURRENTLY BEING PREPARED AND THE SBICS WILL BE REQUIRED TO COMPLETE AND RETURN THE REPORT WITHIN 30 DAYS.

WE BELIEVE THESE STEPS WILL ENABLE US TO IMPLEMENT ON-SITE REVIEW CAPABILITY, WITHIN THE LIMITS OF OUR AVAILABLE RESOURCES, TO SUPPLEMENT THE EXAMINATIONS PERFORMED BY THE IG. IN ADDITION, THE IG IS CONCENTRATING ON THE RESPONSIBILITIES OF THE SBICS' INDEPENDENT PUBLIC ACCOUNTANTS. AN EXPERT IN AUDIT QUALITY CONTROL HAS RECENTLY JOINED THE IG'S STAFF. AS A RESULT, WE BELIEVE APPROPRIATE ACTION WILL BE FORTHCOMING SHORTLY.

IN RECENT HEARINGS, MR. CHAIRMAN, YOU HAVE SUGGESTED THAT AN ON-SITE EXAMINATION OF EACH AND EVERY SBIC BE DONE IMMEDIATELY. WE HAVE REVIEWED YOUR SUGGESTION AND HAVE CONCLUDED THAT, BASED UPON PAST EXPERIENCE, SUCH A

TASK WOULD BE QUITE AN UNDERTAKING. WE HAVE CALCULATED THE COST OF SUCH AN ON-SITE EXAMINATION TO BE APPROXIMATELY $7 TO $10 MILLION.

9) WE ARE ENLISTING THE SERVICES OF THE PRIVATE SECTOR COUNCIL, A NONPROFIT ORGANIZATION OF VOLUNTEERS FROM THE HIGHEST LEVELS OF THE PRIVATE SECTOR, TO ASSIST US IN OUR REVIEW OF SOME BASIC QUESTIONS CONCERNING THE PROGRAM. THE FIRST TASK WE ASKED THEM TO UNDERTAKE IS A REVIEW OF OUR LICENSING REQUIREMENTS. WE HOPE TO HAVE THIS REVIEW COMPLETED IN DUE COURSE AND LOOK FORWARD TO THEIR RECOMMENDATIONS.

OUR BASIC PURPOSE IN TAKING THESE STEPS IS NOT TO INJURE THE PROGRAM, BUT TO ENHANCE ITS SUCCESS. OUR GOALS ARE TO IMPROVE THE AGENCY'S ABILITY TO DETECT PROBLEMS EARLY, TO DEVELOP SOLUTIONS IN A TIMELY MANNER, AND TO SUBSTANTIALLY IMPROVE THE EFFICIENCY OF OPERATING PROCEDURES IN THE SBIC PROGRAM.

IV. LIQUIDATION PROCESS

AS I MENTIONED A MOMENT AGO, OUR SECOND MAJOR AREA OF CONCERN IS THE SBIC LIQUIDATION PROCESS. WE HAVE FOUND THE LIQUIDATION

PROCESS INADEQUATE TO PROTECT THE TAXPAYERS' INTERESTS.

SBICS CAN BE PLACED IN "LIQUIDATION" FOR A VARIETY OF REASONS. HISTORICALLY, MORE THAN HALF WERE PLACED IN LIQUIDATION BECAUSE OF "CAPITAL IMPAIRMENT", WHICH OCCURS WHEN AN SBIC'S PRIVATE CAPITAL IS DIMINISHED BY 50 PERCENT (75 PERCENT FOR SPECIALIZED SBICS). OTHER REASONS FOR PLACING SBICS IN LIQUIDATION INCLUDE DEFAULTS ON PRINCIPAL OR INTEREST PAYMENTS TO THE SBA, AND VIOLATIONS OF REGULATIONS GOVERNING THEIR INVESTMENTS. WHEN AN SBIC GOES INTO LIQUIDATION, THE SBA PAYS THE DEBENTURE HOLDER. THE SBA THEN ACTS TO MAXIMIZE THE RECOVERY OF FUNDS OF AN SBIC IN LIQUIDATION. THESE ACTIONS RANGE FROM LITIGATION, TO NEGOTIATED SETTLEMENT AGREEMENTS, TO UNCONDITIONAL TRANSFERS OF THE COMPANY'S ASSETS TO THE SBA.

AS RESULT OF OUR REVIEW IT IS CLEAR THAT:

1) THE BACKLOG OF SBIC CASES IN LIQUIDATION HAD GROWN TO OVER 170, OWING OVER $500 MILLION TO SBA;
2) THERE WERE ONLY FIVE STAFF MEMBERS AVAILABLE TO HANDLE THESE CASES;
3) THERE WERE SUBSTANTIAL AMOUNTS OF CASH IDLE IN A NUMBER OF THESE CASES;

4) THERE WERE INSUFFICIENT CONTROLS IN PLACE IN THE HANDLING OF SBIC LIQUIDATIONS;

5) SENIOR MANAGEMENT WAS NOT INVOLVED IN LIQUIDATION DECISIONS INVOLVING MILLIONS OF DOLLARS;

6) AS CASES ENTERED LIQUIDATION, ASSETS WERE TAKEN IN AT THE VALUE SET BY SBIC MANAGEMENT RATHER THAN ATTEMPTING TO DETERMINE THEIR TRUE CURRENT VALUE FOR THE PURPOSE OF ASSESSING POTENTIAL RECOVERY OR BOOKING CURRENT LOSS.

A DISCUSSION OF SBIC LIQUIDATION PROBLEMS MUST ALSO INCLUDE STAFFING CONSIDERATIONS. THE PRESIDENT'S BUDGET RECOGNIZES THIS PROBLEM AND HAS INCLUDED SEVEN ADDITIONAL STAFF FOR FISCAL YEAR 1991. THE STAFFING PROFILE OF THE SBIC LIQUIDATION AND PORTFOLIO MANAGEMENT SECTION OVER THE LAST DECADE HAS BEEN SKELETAL AT BEST AND, DUE TO BUDGET CONSTRAINTS, HAS FAILED TO KEEP PACE WITH INCREASED ACTIVITY, BOTH IN NUMBERS AND COMPLEXITY OF CASES.

FROM 1980 THROUGH 1989, SBA AVERAGED TWO TO THREE FULL-TIME EMPLOYEES ON ITS SBIC LIQUIDATION STAFF WITH ADDITIONAL ASSISTANCE FROM SIX OUTSIDE CONTRACTORS IN RECEIVERSHIP CASES. IN 1980, THE LIQUIDATION PORTFOLIO WAS AT $100 MILLION. BY 1989, THE PORTFOLIO HAD GROWN STEADILY IN SIZE TO ALMOST $500 MILLION, WHILE THE STAFFING IN THAT YEAR ONLY GREW TO FIVE FULL-TIME EMPLOYEES. IN RECOGNIZING THIS PROBLEM, I SUBMITTED TO THE OFFICE OF MANAGEMENT AND BUDGET (OMB) A REQUEST FOR FISCAL 1991 - SEVEN NEW FULL-TIME EMPLOYEES WILL BE ADDED TO THIS FUNCTION. FIVE OF THESE ARE ALREADY ON-BOARD.

IN ADDITION, MANY OF THE SALARIES OFFERED AT OTHER AGENCIES (E.G. FDIC, RESOLUTION TRUST CORPORATION, OFFICE OF THRIFT SUPERVISION, ETC.) FOR COMPARABLE FINANCIAL AND SPECIALIST POSITIONS ARE OFTEN AT LEAST ONE GRADE HIGHER THAN THOSE AT SBA, WHICH OBVIOUSLY MAKES RECRUITMENT AND RETENTION VERY DIFFICULT. IN SAVING A FEW THOUSAND DOLLARS IN SALARIES OFFERED TO THESE QUALIFIED EMPLOYEES, WE MAY BE LOSING MILLIONS IN UNCOLLECTED GOVERNMENT FUNDS. STILL, WE CONTINUE TO MAKE A GREAT DEAL OF PROGRESS DESPITE AN OVERWORKED AND UNDERPAID STAFF.

THERE HAS BEEN AN UPTURN IN SBIC DEFAULTS SINCE 1985. FROM AN AVERAGE OF 13 ANNUALLY IN THE FIVE YEARS ENDING ON SEPT. 30, 1985, THE AVERAGE NUMBER OF SBICS PLACED IN "LIQUIDATION" ANNUALLY HAS DOUBLED TO 26 OVER THE LAST FIVE YEARS. MOST DISTURBING ARE THE SIZE AND COMPLEXITY OF SBICS GOING INTO LIQUIDATION IN THE LATTER PERIOD. THE TWO LARGEST LIQUIDATIONS IN THE HISTORY OF THE PROGRAM HAVE OCCURRED IN THE LAST YEAR.

THE SBIC PROGRAM IS PERHAPS SUBJECT TO MORE RISK FACTORS THAN MANY VENTURE CAPITAL FIRMS, BECAUSE SBIC INVESTMENTS ARE LIMITED TO SMALL BUSINESS DEALS. SINCE THE PROGRAM'S INCEPTION IN 1958, 465 SBICS HAVE BEEN PLACED IN LIQUIDATION OUT OF A TOTAL OF 1,597 SBICS LICENSED. SINCE 1958, THE SBA HAS MADE $600 MILLION IN PAYMENTS TO SBA-GUARANTEED DEBENTURE HOLDERS. DURING THE SAME PERIOD, SBICS DEFAULTED ON $100 MILLION IN DIRECT "PREFERRED STOCK" OUTLAYS.

THE COMMITTEE HAS ASKED WHY THERE HAS BEEN AN UPTURN IN SBIC LIQUIDATION. THERE ARE MANY FACTORS THAT MAY HAVE CAUSED THIS TREND, INCLUDING:

A) THE "BURSTING" OF THE HIGH-TECHNOLOGY INVESTMENT BUBBLE OF THE LATE 1970S AND EARLY 1980S;

B) THE 1987 STOCK MARKET COLLAPSE, WHICH DEPRESSED STOCK PRICES AND SERIOUSLY LIMITED OPPORTUNITIES FOR TAKING YOUNG START-UP COMPANIES PUBLIC AT FAVORABLE STOCK PRICES; AND

C) GREATER COMPETITION FROM OTHER CAPITAL SOURCES FOR FEWER GOOD DEALS WITH SUFFICIENTLY HIGH RETURN ON INVESTMENT POTENTIAL.

AS OF JULY 31, 1990, WE HAVE TAKEN THE FOLLOWING ACTIONS:

1) RECOVERED $14.3 MILLION IN CLOSING OUT 24 SBIC LIQUIDATION CASES AND WRITTEN OFF $24 MILLION AS UNCOLLECTIBLE. TWENTY ADDITIONAL CASES TOTALLING $76 MILLION ARE TARGETED FOR RESOLUTION BY THE END OF THE CALENDAR YEAR.
2) IDENTIFIED CASES IN WHICH SBICS IN RECEIVERSHIP HAVE EXCESS CASH IN THEIR ACCOUNTS AND MOVED, WHERE APPROPRIATE, TO HAVE THE EXCESS CASH TRANSFERRED TO THE SBA. WE ARE ACTIVELY PURSUING THESE CLAIMS THROUGH THE COURTS AND IN ONE CASE HAVE COLLECTED OVER $1 MILLION IN CASH.
3) COMPLETED LIQUIDATION PLANS ON A MAJORITY OF THE SBICS IN ACTIVE RECEIVERSHIP PROCEEDINGS.
4) REVISED LIQUIDATION PLANS FOR FIVE SBICS THAT HAVE NOT COMPLIED WITH THEIR EXISTING SETTLEMENT AGREEMENTS.
5) IMPLEMENTED REVISED PROCEDURES TO INDEPENDENTLY VALUE THE ASSETS OF SBICS THAT ARE IN LIQUIDATION AND THE ASSETS ACQUIRED FROM FAILED SBICS THAT VOLUNTARILY ASSIGN THEIR ASSETS TO THE SBA.
6) REVISED INTERNAL ACCOUNTING PROCEDURES TO ENSURE THAT LOSSES ANTICIPATED IN LIQUIDATION PROCEEDINGS BE

RECOGNIZED IMMEDIATELY UPON TRANSFER OF AN SBIC'S ASSETS TO THE SBA.

7) ESTABLISHED NEW PROCEDURES TO INVOLVE SENIOR MANAGEMENT IN THE LIQUIDATION PROCESS, INCLUDING STRENGTHENED GUIDELINES FOR APPROVAL OF EXPENDITURES RELATING TO THE LIQUIDATION OF ACQUIRED ASSETS.

8) DEVELOPED AND STARTED IMPLEMENTING NEW OPERATING PROCEDURES FOR SBICS IN RECEIVERSHIP. WE HAVE ALSO RESTRUCTURED THE OFFICE OF SBIC LIQUIDATION.

9) UPDATED OUR LIQUIDATION PROCEDURES MANUAL IN DRAFT FORM, WITH A FINAL DRAFT SCHEDULED FOR SEPTEMBER 30.

V. CONCLUSION

IN SUMMARY, THE PURPOSE OF ALL OF THE ACTIONS TAKEN THUS FAR IS TO MAKE THE SBIC PROGRAM MORE EFFECTIVE AND EFFICIENT AND LESS COSTLY TO THE GOVERNMENT. SBICS HAVE BEEN AND WILL CONTINUE TO BE A SOURCE OF CAPITAL SO DESPERATELY NEEDED AT THIS TIME BY SMALL BUSINESSES. BUT WITHOUT QUESTION, THE PROGRAM NEEDS THOROUGH REVIEW AND CORRECTION OF ITS PROBLEMS. AS I HAVE TESTIFIED, I BEGAN THIS REVIEW LAST YEAR AND IT IS CONTINUING.

I WANT TO THANK THE CHAIRMAN AND THE MEMBERS OF THIS COMMITTEE FOR YOUR STRONG INTEREST IN THE HEALTH OF THE SBIC PROGRAM AND YOUR INVALUABLE ASSISTANCE IN IDENTIFYING SOME OF THE PROGRAM'S PROBLEMS. I WILL COUNT ON YOUR CONTINUED SUPPORT AS WE MAKE THE DECISIONS AND TAKE THE STEPS NECESSARY TO CORRECT THE PROGRAM'S DEFICIENCIES. SOME OF THESE STEPS MAY INVOLVE LEGISLATIVE CHANGES. I WILL, OF COURSE, KEEP YOU INFORMED OF OUR PROGRESS.

WE HAVE STARTED BY TAKING REMEDIAL STEPS THAT WILL LIMIT THE AGENCY'S VULNERABILITY TO FINANCIAL LOSSES BY PROVIDING MORE EFFICIENT AND TIMELY IDENTIFICATION AND RESOLUTION OF PROBLEMS IN THE PROGRAM. THEY WILL ALSO PROVIDE LESS COSTLY LIQUIDATIONS OF SBICS. THESE STEPS ARE ESSENTIAL TO SBA'S ABILITY TO MINIMIZE THE GOVERNMENT'S EXPOSURE FROM THE PROGRAM WHILE CONTINUING ACTIVE GOVERNMENT ENCOURAGEMENT FOR PROVIDING VENTURE CAPITAL TO SMALL BUSINESSES.

I WILL BE PLEASED TO RESPOND TO ANY QUESTIONS YOU MAY HAVE.

Additional Questions for Mrs. Engeleiter

(1) Q. Mme Administrator, what specific steps have you taken in the area of portfolio management to (a) ensure that we have an adequate valuation of these assets and (b) recover the government's loss by the sale of investments owned by failed SBICs to other investors?

--With respect to the latter, is legislation or regulatory change needed to facilitate this process? My concern is that portfolio management has been something of a "black hole" into which failed companies fall, never to be heard from again. There must be some value in these companies, and presumably there are other venture capitalists, including SBIC's who would be interested in purchasing these assets.

--What additional resources have been given to the office of portfolio management?

A. a.) The procedure whereby SBIC assets were accepted by SBA at the value placed upon them by SBIC management has been changed. Those assets that are salable are now taken in at their reasonably anticipated value. Adequate valuation of the portfolio companies that represent equity investments is an extremely difficult task because there is no ready market against which to set a value. The Agency did receive two contract proposals to develop a system for both the evaluation and sale of portfolio assets of SBICs in liquidations status, but felt the costs were very high. At present, the Agency is exploring ways in which a system could be developed to make existing SBICs aware of these assets and permit the SBICs to bid on them.

b.) Not all such assets are appropriate for sale. For instance, if a portfolio company of a failed SBIC is paying its obligation on a regular basis, that asset can be taken into a SBA District Office portfolio and serviced just like a 7(a) loan. This would result in the best recovery for the Agency on that asset.

We do not believe that either legislative or regulatory change is required to facilitate this process. We also do not believe that portfolio management has been a "black hole". The nature of the liquidation of equity investments simply requires a maturing that can take an extended period of time. To the extent that process is rushed, recoveries are diminished.

With regard to additional resources, seven additional slots were requested in the FY 1991 budget proposal. In the emergency situation we faced, five of those slots were filled in the last several months by borrowing the slots from another program. Total staffing in this activity now stands at 10 directly involved, plus management time devoted to this program.

(2) Q. I am considering requesting a General Accounting Office (GAO) study of this program, or at least of portfolio management, to get a better handle on some of the difficult accounting problems presented in these hearings. Would SBA be willing to cooperate with our Committee staff in framing such a study, and do you believe such a study would be helpful?

A. Of course SBA would be willing to cooperate with the Committee staff in any reasonable endeavor to assist us to better accomplish the mandate of the Small Business Investment Act. However, in view of our review of the program and the hearings of this Committee, we believe we have a pretty good idea of the problems involved in the program, including portfolio management, and the accounting problems.

We are actively taking steps to tighten up some of the accounting requirements, as detailed in my statement at the hearing. In addition, the Inspector General is instituting a quality review program of the Independent Public Accountants (IPA) reports of SBICs. This will include a desk review of all IPA reports and a sample of working papers to ensure they meet professional auditing standards. In view of these developments, we believe a GAO study at this time may be premature. If our review of the program and the corrective actions taken should indicate the necessity for additional, outside study, we will not hesitate to take appropriate action. There are many consulting organizations that could provide such services, including GAO, The National Academy of Public Administrators, the Private Sector Council, etc.

(3) Q. You stated that a request was submitted to OMB for additional personnel in the Office of Portfolio Management to handle the drastic increase in SBIC liquidations. Was this request approved and is it reflected in the President's budget proposal for FY '91?

A. As indicated above, a request for seven additional slots for this activity was submitted to OMB, and was included in the President's budget proposal for FY 1991.

(4) Q. I saw an SBA news advisory recently indicating that SBA had accelerated a 10-year SBIC debenture effective July 3, 1990. What does this mean and why is it newsworthy?

A. A press release is issued announcing the acceleration of SBIC debentures which make up a pool which underlies participation certificates sold to the public and traded in the secondary market. The press release is intended to provide acceleration information to prospective purchasers in the secondary market.

This procedure was requested by the underwriters who market this paper and each "Offering Circular" announcing the sale of participation certificates in a pool of SBIC debentures contains a statement to the effect that SBA will make such information available in a press release.

(5) Q. You stated in your testimony that program oversight was "unnecessarily split" between two offices, i.e. the Investment Division and the Inspector General (IG). Are you suggesting that the IG should not have a role--that the audit function should be shifted back to the Investment Division as it was many years ago?

A. The reference to SBIC oversight being "unnecessarily split" and the fact that no one office had full oversight of the program refers to the functional split between three units, that is, the Investment Division, the Office of Portfolio Management and the IG. I have reviewed the split function of the first two offices and have determined that the liquidation responsibility for SBICs should appropriately be in the Investment Division.

With respect to the IG, I believe that official should have a continuing role in the operation of the SBIC program. In addition to the usual audits of the SBIC program and all other Agency programs, I would like the IG to continue the SBIC biennial examinations which cover not only a financial review, but also a regulatory review. These examinations, by IG personnel who are trained in audit procedures, have a factfinding purpose. Their reports should indicate areas of questionable practices in both financial and regulatory matters for appropriate followup action by the Investment Division. Neither Investment Division personnel nor an Independent Public Accountant hired by and responsible to the SBIC should be relied upon to perform this function. In this manner, both the investigative responsibility and expertise of the IG and the programmatic responsibility and expertise of the Investment Division will best be served.

However, in any such situation, the role of the IG must be limited to the proper function of an IG and not allowed to cross the line into program management or operation. The IG is, and should remain, an independent, objective official free from SBIC programmatic responsibilities who can audit SBA's conduct of the program to help avoid instances of waste, fraud, abuse and mismanagement.

In the past, the Investment Division has relied too heavily on the annual, (now biennial) examination of the SBICs by the IG. As I indicated in my statement, I believe this has contributed to spotty Government oversight and supervision of the program. I have made it clear to the present management of the program that I expect the Investment Division to be more familiar with the condition and operations of specific SBICs in the future, within the limits of available resources.

(6) Q. Could you elaborate on the Private Sector Council and its role in the program?

A. The Private Sector Council is a non-profit private organization through which the expertise represented in the executive talent of private concerns in many diverse fields are made available to the Federal Government at no cost to the Government. The organizations represented include many of the major business and professional and academic establishments of the country and represents a wealth of experience.

SBA is using the Council as a consultant to provide an independent, expert review of many specific areas of our program implementation, including licensing requirements, funding request review procedures, portfolio evaluation procedures, etc. Both we and the Council are very mindful of the possibility of conflicts of interest in this process and are taking appropriate steps to avoid problems.

(7) Q. Why are agencies like RTC and FDIC able to pay more for liquidation than is SBA? Is this due to a lack of appropriated funds or to constraints imposed by OMB or OPM?

A. As nearly as we are able to determine, neither RTC nor FDIC are bound by the same grade and pay standards imposed on SBA by the Office of Personnel Management.

(8) Q. Has SBA evaluated the proposal submitted by NASBIC and NAIC re guidelines for evaluation of portfolio securities and other changes in the program. If so, please share with the Committee any such evaluation. If not, will you do so within 60 days?

A. The proposal by NASBIC and NAIC concerning evaluation guidelines were submitted to SBA after the testimony. As I stated in my testimony, we are reviewing the entire question of SBIC portfolio valuation and certainly will consider the industry's suggestions in that review. We are pleased that the industry has given careful consideration to this issue and will give their suggestions the weight they deserve. We expect to complete this review within 60 days and take appropriate action. Of course we will keep the Committee informed of all action in this matter.

The **CHAIRMAN**. Thank you very much, Ms. Engeleiter. First, I want to compliment you on that statement for its candor and its thoroughness. That is the kind of information this Committee needs in order to assist you and to make sensible decisions.

And when I think about how many committees I serve on and the testimony that I sit through on a daily basis, it is seldom that somebody comes in and provides this thorough and this detailed information. And while there may be some disagreements on the strength of your proposals and there may be some disagreement about them generally, at least you have identified the problem in much more specific and dramatic terms than we have had before. And certainly none of us can decide where we want to go with this program without that information. And so I want to thank you very much.

Ms. **ENGELEITER**. Thank you.

The **CHAIRMAN**. And I thank OMB for letting you come over here and say that, which I did not think they would do.

Ms. **ENGELEITER**. On behalf of OMB, I am sure they appreciate the compliment, also.

The **CHAIRMAN**. Which brings me to one of my first questions. If the normal rule of thumb is one employee for each $10 million of value in liquidation, and you have five employees and you are going to get five more, or 10 employees. And yet we are dealing with at least $500 million in liquidation, which would translate into at least 50 employees, you are 40 employees short.

Now, I watched Ed Gray, who incidentally is not my favorite person in the whole world—he has been busily covering himself ever since the S&L debacle—but I watched him on CBS last night say something that made a lot of sense. He said he went to the White House and he told somebody there, who he did not name, that the S&L crisis was indeed a crisis about to become a debacle, and that he needed a lot of auditors. And he was told by the unnamed person at the White House, you do not understand, Mr. Gray—these are his words on CBS last night: "This Administration is not in the auditing business. This Administration wants to get the Government off the back of business." And so he said he was sent packing with no new employees.

Now, in all fairness, Mrs. Engeleiter, it seems to me that giving you five additional employees, which is precisely—it gives you about 20 percent of the people you need to carry out these liquidations. It seems to me that while they gave you something, they left you far short of being able to do a decent job on these liquidations. What would your comment be on that?

Ms. **ENGELEITER**. In fairness to them, if you remember the chronology of events here, in terms of discovering the extent of the problems in the program, our knowledge stemmed from the Inspector General's audit that was done late last year on one particular liquidation, that of Royal Business Fund. As a result, I brought in an independent outside firm to take a look at the whole function, and we received reports from them in stages that indicated that the problems were much more extensive than one particular handling of a liquidation.

At the time, we felt that we were understaffed and did request seven positions, and seven were granted by the Office of Management and Budget. And we have filled five and will fill the additional two, so we will be up to 12. At the time, the problem was not of this magnitude and we certainly will be going in for next year's budget and requesting more positions. Hopefully that will be looked upon kindly.

But in the meantime, now that we have had more SBIC's going into liquidation, some very large ones, as you are well aware, we do need the additional staffing. It certainly would be helpful.

The CHAIRMAN. If I marked the right pages, on page 16 of your testimony, the backlog of SBIC cases in liquidation has grown to over 170 owing over $500 million. And you also stated that historically we have had 13 or 14 liquidations a year since the inception of the program. And apparently we have already had 26 this calendar year.

Ms. ENGELEITER. That is correct.

The CHAIRMAN. Now, if I am reading the tea leaves right about the future of the economy—of course I am sort of like Henry Kaufman, I have predicted six of the last two recessions. [Laughter.]

But I am quite sure that my prediction this time is going to come true. I really think the economy is in deep trouble. And that does not bode well for this program. Small businesses will be the first ones to go belly up. And I think we are probably looking at a lot more liquidations in a program than there might be, but because of the future economic conditions that are already beginning to develop, we are going to have maybe a tripling or quadrupling of the number of liquidations.

And for us to be sitting here now saying that you have five employees, but you hope to get more next year, I think is a prescription for more disaster in this program, Ms. Engeleiter.

Ms. ENGELEITER. That is why I am raising the issue and discussed with you here this morning. We do expect to close out a number of those 170 liquidations that are pending rather rapidly. And perhaps Mr. Kulik would like to elaborate on that for you.

Mr. KULIK. Some of the SBIC liquidations in that 170 do not take that much action. They are the subject of workout agreements. The agreements are being honored as the obligations come due, and it is really a bookkeeping matter.

But I might also add, Senator, that in a number of these cases, with the authority that we have under the law, we are using receiverships and we do have outside contractors in receivership cases who augment the staff that we have on board, as well as the help that we get, of course, from our own Office of General Counsel.

The CHAIRMAN. Berky, that is encouraging, and I am glad to hear that because that can make up for some of the shortfall you are faced with.

Ms. ENGELEITER. If I might add something to that, Mr. Chairman.

The CHAIRMAN. Yes.

Ms. NAREY. One of the things that we are trying to do is to review outstanding SBIC receiverships. In the past, some of these cases were sent to the field and languished there.

We are now trying to account for all of the cases that are out there that are in liquidation in our field offices; find out which ones are old, are first sitting there and really need nothing more than to go into the courts and close them. As more cases come into liquidations we will attempt to develop a standard, in terms of action to be taken. As a result, if there is nothing to be gained, we can close the case and be done with it. This will give us a process by which to administer these cases as they go into receivership or liquidation.

The CHAIRMAN. Let me ask you an additional question. Historically, you said in your testimony, I think—I want to make sure this is the scrubbed version—that traditionally, we have recovered 62 percent of the indebtedness. Is that correct?

Mr. KULIK. Sixty-four percent.

The CHAIRMAN. That has been declining pretty dramatically, has it not?

Mr. KULIK. In the current crop, if I can use the word, of liquidation cases, it will decline. Yes.

The CHAIRMAN. How do you account for that? Why is that? Why is the recovery declining so precipitously?

Ms. NAREY. I think one of the reasons, at least to my understanding, is that some of the investments that the SBIC's have made in recent years have been in ventures that are more difficult to value, harder to make recoveries on than when the SBIC Program was initially begun when investments may have been in more traditional ventures.

The CHAIRMAN. Well, I will say this. I mean, this did not happen on your watch, Ms. Engeleiter, and your statistics here—I forget. What was it? Sixty? A 66 percent decline in personnel and resources to administer this program at a time when our losses were going up 382 percent. Now, if that is not two ships passing in the night, I do not know what would be.

It just blows my mind to think about, frankly, the taxpayers of this country having to pick up the $½ billion or more. And actually, you know, despite the successes of this program—and there have been successes—despite the successes of this program, when you consider that almost a third of all those that have ever been licensed have gone into liquidation, that does not really sound very good. It does not sound good to the taxpayers; it does not sound good to me.

And one of the reasons I was anxious to get you here is because, you know, I think we are probably going to continue this program, and all of the strong measures you are taking here are welcome. But I mean, this Committee needs to be assured and the American public needs to be assured that these are calculated to make certain that we have the personnel to actually audit these people and stay on top of them so that we do not have these kinds of losses in the future.

The losses, for example, Berky, as I understand it, we are going from about a 62 percent recovery of those in liquidation down to something like 40 percent recovery.

Mr. KULIK. Forty percent to 50 percent.

Ms. ENGELEITER. Mr. Chairman, I think it is important to point out, though, that we are writing off losses that have been carried for a number of years, that should have been, in some cases, written off years ago. I mentioned in my testimony that there were receiverships as old as 20 years. And it is very unfortunate for this particular program, which is a good program, to have the public relations problem for a year or two while we are writing off these losses that should have been written off in the past.

You have an artificially high loss record for this period of time that is not really accurate. If these losses had been written off over the years in an appropriate fashion, we would not be in the situation that we are in today and have the program look as though it is worsening when it is, in fact, not worsening to that extent.

Perhaps Mr. Crusto would like to elaborate.

Mr. CRUSTO. Mr. Chairman, if I can give you a little bit of an overview. We have had $9 billion involved in this program—in total. The Federal Government has had $3 billion involved; $1.1 billion has been repaid. We have outstanding $1.2 billion, and approximately $700 million is in liquidation. Of the liquidation amount, of $700 million and we have collected $150 million, we have written off $50 million. And that leaves the $500 million present balance in liquidation.

We believe we will collect approximately 50 percent with our present numbers—historically it has been 64 percent—which leaves about $221 million to be written off. In total, that would mean a writeoff of about $270 to $290 million in a program that has had $3 billion in Government participation and $9 billion total.

And as you mentioned earlier in your introduction, the tax benefits that have been received as a result show that in total it has been a very beneficial program to the economy and to America's small businesses. But at the same time, we do have this balancing act between assisting small business and at that same time protecting the Government—taxpayers' dollars.

The CHAIRMAN. Well, losses in 1980, as I understood, you were $100 million as of that time.

Mr. CRUSTO. $100 million in liquidation, sir.

The CHAIRMAN. I'm sorry. $100 million in liquidation in 1980, and now in 1989, that had quintupled to $500 million.

Mr. CRUSTO. That is correct. But once the loans go into liquidation, they are subject to collection by the Agency; they are not lost dollars. Those dollars are subject to collection and that is why we go through the liquidation process.

The CHAIRMAN. Ms. Engeleiter, can you hang around for a minute while we go vote?

Ms. ENGELEITER. Sure. We would be happy to.

The CHAIRMAN. Let me see. We have got a couple more minutes.

Bob, would you like to start questioning Ms. Engeleiter or you want to go vote and then come back?

Senator KASTEN. I will go through a couple of questions and that will save a little bit of time. I will make a brief statement. We have about 10 minutes before the vote?

The CHAIRMAN. We have probably 9 minutes to get to the floor.

STATEMENT OF HON. ROBERT W. KASTEN, Jr., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KASTEN. Let me, first of all, say that I think that the statement did not say, "While Government losses have increased

382 percent." It said, "While Government risk of loss has increased 382 percent." And I think that that is the point that the gentleman and the Administrator are trying to make.

Your point, though, Mr. Chairman, I think is still well taken. The fact is that resources have diminished as responsibilities have grown, but resources have not necessarily diminished as losses have grown. But it still, I think, makes a very strong point that staff resources being cut by 66 percent does not make sense in terms of what we are doing and how we want to try to administer this program.

But let me first of all commend Administrator Engeleiter for her statement. I agree with your statement, Mr. Chairman, but also with her decisive actions to strengthen the Small Business Investment Company Program. The SBIC's, I believe, have played an important role in raising venture capital for small business startups, and I think it is important to point out that what we are talking about, basically the whole concept here is one of backing companies that are inherently more risky than average kinds of companies.

The reason that we have got this setup here is these are companies, these are risk-takers, these are entrepreneurs that are in effect more entrepreneurial and willing to take greater risks than can be financed in the traditional kinds of ways. So, almost by definition, we have got risk-takers. That means they are going to be big winners but there also are going to be some losers. And the question here is to encourage the winners and to manage the losers. And that seems to me what we have got to do.

But by the nature of this program, it is going to have losses. That is the way it works, and I think that we just have to be understanding in terms of managing the losses. But these are risky investments, but we, in our country, want to encourage risk and entrepreneurship.

I think that the role that the SBIC's have played has been an important role in terms of raising venture capital for small business startups. The Administrator's 90- day moratorium on licensing SBIC's, to tighten regulatory procedures, review accounting practices, speed the liquidation of troubled SBIC's, I believe, will put the program back on the road to solvency. I think the steps that have been outlined here this morning are important.

I also agree, Mr. Chairman, that we need to be supportive in this Committee in terms of establishing or providing the resources that are needed by the Small Business Administration.

Some of the losses in the program have been due to mismanagement and some have been due to fraud. And I think it is important that we state that flat out. There is mismanagement, there has been fraud, and I think the Administrator has told us that this morning. But it is important also to note that many of the SBIC's that are experiencing trouble today were licensed before the SBIC licensing standards were significantly strengthened in 1983, and obviously before the activities that have been taken over the past several months by Administrator Engeleiter.

So we have kind of two steps here and a number of the ones that are in trouble are before even the 1983 efforts.

I believe that the bulk of the SBIC's losses is due to the fact that the venture capital market has stagnated. And Administrator Engeleiter made a couple of statements with regard to the stock market crash and other kinds of things.

I personally think that it is due to the capital gains increase, the capital gains tax being raised in 1986. That was a 65 percent capital gains tax increase, which dramatically reduced incentives, I believe, to invest in risky ventures. New venture capital commitments accelerated from $68 million in 1977, when the top tax rate was 50 percent, to $5.1 billion in 1983, when the tax rate was reduced to 20 percent. Between 1986 and 1988, when the capital gains tax was raised from 20 percent to 33 percent, the number of public stock offerings plummeted by more than 60 percent, and the amount of dollars raised has remained essentially flat, despite the economic expansion.

The 1982 to 1986 period, when we had a low capital gains tax, new business formations rose at 5.7 percent. Since the 1986 capital gains tax rate increase, new business formations declined by 3 percent. So if the venture capital industry is weak, then logic dictates that SBIC's will naturally experience financial problems.

In addition to reviewing the regulatory and management efforts that have been undertaken to strengthen the SBIC Program, I hope that we can examine the impact of the underlying economic fundamentals of the program's financial condition. And I think that the efforts that have been made by the Small Business Administration under Ms. Engeleiter's strong leadership are the beginning of our effort to start to examine some of these fundamentals. But in addition, we have to recognize the efforts and the problems that we have got to continue to make and solve.

I had two or three questions with regard to personnel levels, and I think they were adequately covered, Mr. Chairman, so I have no further questions.

The CHAIRMAN. Ms. Engeleiter, rather than have you sit here and wait, because we could have back-to-back votes there, I had a few more questions that I can submit to you in writing.

I just want to make one comment, and that is I think I agree with part of what Senator Kasten said. But before you can benefit by a capital gains tax, you have got to have a viable, profitable institution. And you cannot sell stock in a failing company and you cannot get a gains rate in a failing company.

And I am concerned. I just want to express for the record, my concern, No. 1, about the ability of the SBA to audit the internal measurements by SBIC's on their portfolio valuations. I think that is the most fundamental part of the problem.

And second, I want to make sure that you are not suggesting that the Inspector General—you said something about splitting the Investment Division and the Inspector General. You are not suggesting that the IG not have a role in the audit function, are you? That it just be shifted back to the Investment Division?

Ms. ENGELEITER. No, I wasn't suggesting that at all. My reference was to the part that the liquidation process is separate from the licensing process within SBA currently.

The CHAIRMAN. I think that might be a violation of the law anyway if we did that.

Ms. ENGELEITER. No. I was not suggesting that.

The CHAIRMAN. And finally, I wanted to ask you if we could get a copy of this outside contractor's report and evaluation study. On page 13 you say, "In addition to the IG's special study, at the request of the Investment Division, an outside contractor has completed an evaluation study of a related group of SBIC's. A draft report of that study was delivered this week to the Investment Division and is currently being reviewed for appropriate action." Is there any reason why the Committee should not see that report?

Mr. KULIK. We only have, at this point, a draft report. There is no final report.

The CHAIRMAN. When will it be finalized?

Mr. KULIK. I hope this week—well, there is not much left of this week——

The CHAIRMAN. Well, let me rephrase the question. When you finalize it, is there any reason why the committee should not see it?

Ms. ENGELEITER. I can think of no reason unless there is some legal reason that we are not aware of. We would be glad to share that with you as soon as we have a final report.[1]

The CHAIRMAN. I would like that. OK.

Ms. ENGELEITER. And also, Senator, if I might, we would like to work with you in terms of trying to locate funding within this year's budget at the SBA for the $7 million to $10 million. And we would like to have some ongoing discussions with you as to how to find it. You and the Committee Members.

The CHAIRMAN. I do not believe you have the resources to hire enough outside auditors and contractors to do this. And you need some people on board, and I know you have salary constraints, but I consider that—because I want to make this point. I think the economy is in big trouble right now, and I think that problem is liable to mushroom as a result of that. And I think the kinds of losses that we are going to sustain are going to continue and the number of SBIC's in liquidation are going to grow. And that is an even more important reason to get on it right now and try to preserve assets and minimize our losses, which I feel are certainly coming.

Ms. ENGELEITER. We totally agree.

The CHAIRMAN. And thank you again for being with us.

To the other witnesses, we will return as quickly as possible. [Recess.]

The CHAIRMAN. We have a panel consisting of Mr. Hugh Ewing, III, general partner, Hillcrest Group in Richmond, representing the National Association of Small Business Investment Companies, and Mr. James Fletcher, chairman of the board, Neighborhood Fund, and president of the South Shore Bank of Chicago, which has a fine interest in Arkansas in which we all take great pride, representing the National Association of Investment Companies.

Gentlemen, before you testify, Senator Harkin has joined us and has asked for permission to make a statement, which is hereby granted.

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[1] Material referred to retained in Committee files.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM THE STATE OF IOWA

Senator HARKIN. Mr. Chairman, thank you. I just wanted to state, Mr. Chairman, that I followed the SBIC for a long time. They have a good mandate.

And basically I am just really concerned that the SBA, over the last several years has not really put the resources into auditing and into the manpower that is needed to make the program run. It is a philosophy of hands off, an attitude that has prevailed over the last several years and, again, these programs, in order to run and to run properly, need to be managed properly. To be managed properly, they need the personnel.

Quite frankly, now we are facing around $500 million, I guess is what——

The CHAIRMAN. That is the potential loss.

Senator HARKIN. The potential loss that I am seeing now. And I think again that this points out the necessity of insuring that we have the personnel to make these programs run. I mean, if you are going to have the programs, do it. If not, then just knock them out.

I basically believe the SBIC has performed a good function in the past for a lot of minority businesses, for small businesses to give them capital to get going. But it is obvious that it has been totally mismanaged and misrun over the last several years. And I look forward to getting the testimony from the witnesses that are here today and also to follow through with you, Mr. Chairman, on how we make sure that this does not happen again and make sure that SBA has better oversight and better management of these programs than they have had over the last several years.

With that, I will just say I appreciate it.

The CHAIRMAN. Thank you, Senator Harkin.

Senator Levin, did you have any statement?

Senator LEVIN. Just briefly, I also have a statement for the record.

STATEMENT OF HON. CARL LEVIN, A U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. I want to thank you for your leadership in holding these hearings. I share Senator Harkin's sentiments. We have a lot to be worried about, a lot to oversee to make sure that we do not have a disaster or mini-disaster in this program. And I am glad you are taking this initiative, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Levin. Senator, while we are indulging everybody, our Ranking Member has shown up.

Do you have an opening statement, Senator Boschwitz? You have 15 seconds. [Laughter.]

STATEMENT OF HON. RUDY BOSCHWITZ, A U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator BOSCHWITZ. I thank the Chairman for holding the fourth in these series of hearings. It is, as the Senator from Michigan suggests, an important hearing because there have been some irregularities in this program. And it is well that we exercise the oversight that was intended.

I understand that the Administrator of the SBA has taken some independent action already, for which I compliment her. And I think that she is very determined to see to it that we do not have a renewal of some type of debacle that would be embarrassing either to the SBA or to the Administration.

The SBIC Program, I am convinced, has served this country well and has been really quite a creative force in the area of small business. It is important that, through these hearings and through the efforts of the SBA, the program continue in the constructive role that was intended and that it has played over the years.

It is, I suppose, human nature that programs are abused despite the best attempts at oversight either by this Committee or by the Administration itself. And it is well that these problems of abuse be brought to light so they can be corrected and the program can move forward.

Mr. Chairman, I run in and I run out, and I apologize for that because I take an interest in this program. I have three other conflicting appointments. I will carefully review the record and have my staff do so as well. I believe your feelings are similar to mine that this program is a program that is worthy of being continued providing we can eliminate the abuses. I would like my prepared statement submitted in its entirety for the record. Thank you, Mr. Chairman, for holding this hearing.

[The prepared statements of Senators Levin and Boschwitz follow:]

Statement of Senator Carl Levin

August 2, 1990

Mr. Chairman, I am glad that you have scheduled these hearings. The Small Business Investment Company program has historically been a useful tool for the development of successful small business ventures. SBICs have generated jobs and profits all over the country. I have been a strong supporter of SBICs role in this regard.

Unfortunately, these hearings have uncovered that the SBIC program needs better supervision and management, and maybe some structural changes. It takes a long time to build a successful SBIC, so it took an equally long time to discover that the program needs improvement. I am glad that Administrator Engeleiter could be here this morning to tell us what she is doing to improve the program, and what action, if any, Congress should take.

I hope that the cases that the Committee had before it in recent months are not the tip of the iceberg. I get more than a little concerned when I see, even in a worst case scenario, projected losses to the U.S. Treasury exceeding half a billion dollars. Though this figure is hypothetical, based on an assumption that the 170 SBICs in liquidation would be a total loss - owing nearly half a billion to SBA, its realization is not impossible.

I look forward to reassurances from Administrator Engeleiter and our other witnesses, that the problems are being or will be fixed soon. Then, we can return an adequately funded SBIC program loose on the market again to encourage successful small business formation and operation.

STATEMENT OF SENATOR RUDY BOSCHWITZ
HEARING ON THE
SMALL BUSINESS INVESTMENT COMPANY PROGRAM
SMALL BUSINESS COMMITTEE
AUGUST 2, 1990

THANK YOU, MR. CHAIRMAN, FOR CONDUCTING THIS FOURTH HEARING ON SBA'S SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM. IN PREVIOUS HEARINGS, I HAVE EXPRESSED MY CONCERN OVER THE PROBLEMS ASSOCIATED WITH TWO SBICS IN PARTICULAR -- RIVER CAPITAL CORPORATION (RCC) AND ROYAL BUSINESS FUNDS CORPORATION (ROYAL).

AS YOU KNOW, RCC DEFAULTED ON $28.5 MILLION IN SBA GUARANTEED DEBENTURES, OF WHICH ONLY $2-4 MILLION MAY BE RECOVERED. AT AN EARLIER HEARING, QUESTIONS WERE POSED TO THE GENERAL ACCOUNTING OFFICE (GAO) ON THE PROCEDURES USED BY THE INSPECTOR GENERAL (IG) DURING ITS INVESTIGATION OF RCC. A REPRESENTATIVE FROM GAO TESTIFIED HE BELIEVED THERE WAS NO WRONGDOING BY THE IG.

GAO WAS ALSO QUESTIONED ABOUT THE ACCOUNTING PRACTICES UTILIZED BY ARTHUR ANDERSEN WHEN AUDITING RCC. ALTHOUGH THE IG BELIEVED ARTHUR ANDERSEN UTILIZED QUESTIONABLE AUDITING PRACTICES, GAO DID NOT AGREE. HOWEVER, GAO DOES BELIEVE OUTSIDE CPAS, WHEN AUDITING FEDERAL LOAN PROGRAMS, SHOULD USE GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS (GAGAS), RATHER THAN GENERALLY ACCEPTED AUDITING STANDARDS (GAAS). HAD ARTHUR ANDERSEN USED GAGAS, THE

RCC BOARD OF DIRECTORS MAY HAVE BEEN PREVENTED FROM OVERVALUATING ITS INVESTMENTS.

GAO ALSO BELIEVES THE AUDIT GUIDE OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS DOES NOT GO FAR ENOUGH IN DETAILING WHAT TYPES OF DOCUMENTATION AND RECORDS SHOULD BE EXAMINED WHEN AUDITING PORTFOLIO VALUATIONS THAT HAVE BEEN DETERMINED BY BOARDS OF DIRECTORS. GAO RECOMMENDS THE AUDIT GUIDE SHOULD REQUIRE AUDITORS TO LOOK BEYOND FINANCIAL AND SUMMARY BUSINESS OUTLOOK INFORMATION.

IN THE CASE OF ROYAL, WE LEARNED OF ITS QUESTIONABLE CONNECTION TO EWE PROPERTIES LTD. (EWE). EWE WAS ESTABLISHED FOR THE PURPOSE OF LIQUIDATING ROYAL'S ASSETS. ALL OF ITS PREFERRED STOCK IS HELD BY THE SBA, AND THE OFFICERS OF THE COMPANY ARE SBA EMPLOYEES.

THE JUSTICE DEPARTMENT HAS AGREED WITH THE IG FINDING THAT EWE WAS FORMED IN VIOLATION OF THE GOVERNMENT CORPORATION CONTROL ACT. IN ADDITION, EWE MAY HAVE COST SBA OVER $11 MILLION BY NOT SELLING ROYAL'S ASSETS IN "AS IS" CONDITION. INSTEAD, EWE USED ADDITIONAL GOVERNMENT FUNDS TO IMPROVE THE PROPERTIES; IT IS UNLIKELY THAT MONEY WILL BE RECOUPED. ALSO, EWE DID NOT KEEP ADEQUATE RECORDS AND, IT IS BELIEVED, SBA MANAGEMENT DID NOT PROPERLY MONITOR ROYAL'S LIQUIDATION.

SINCE THE THREE EARLIER HEARINGS, ADMINISTRATOR ENGELEITER HAS INITIATED MANY CHANGES IN THE SBIC PROGRAM. FIRST OF ALL, SHE PLACED A 90-DAY MORATORIUM ON THE ISSUANCE OF NEW SBIC LICENSES. THE MORATORIUM BECAME EFFECTIVE JUNE 29, 1990.

ALSO, INDIVIDUALS ASSOCIATED WITH THE SBIC PROGRAM AND EWE HAVE BEEN DETAILED TO OTHER ASSIGNMENTS. BERKY KULIK, A HIGHLY RESPECTED SBA MANAGER, HAS ASSUMED THE DUTIES AS ASSOCIATE ADMINISTRATOR OF THE INVESTMENT DIVISION. IN ADDITION, AS RECOMMENDED BY GAO, SBA WILL ISSUE A REGULATION INSTITUTING THE USE OF GAGAS FOR OUTSIDE AUDITORS WHEN AUDITING SBICS.

MR. CHAIRMAN, I BELIEVE THESE ARE ALL VERY POSITIVE STEPS TOWARD CLEANING UP THE SBIC PROGRAM. ALTHOUGH I AM VERY CONCERNED ABOUT THE STABILITY OF SOME SBICS, I BELIEVE THE SBIC PROGRAM ITSELF HAS PROVEN VERY BENEFICIAL TO SMALL BUSINESS. SINCE ITS INCEPTION, THE PROGRAM HAS PROVIDED NEARLY $9 BILLION IN SMALL BUSINESS FINANCING.

I WELCOME ADMINISTRATOR ENGELEITER TODAY AND APPLAUD HER FOR RESPONDING TO THE FINDINGS OF THE COMMITTEE. I AM ANXIOUS TO HEAR OF ANY FURTHER DEVELOPMENTS. I ALSO WELCOME A. HUGH EWING, III, WHO IS REPRESENTING THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, AND JAMES FLETCHER WHO IS REPRESENTING THE NATIONAL ASSOCIATION OF INVESTMENT COMPANIES. I LOOK FORWARD TO THEIR TESTIMONIES.

THANK YOU, MR. CHAIRMAN.

The **Chairman**. Gentlemen, we have quite a bit of action on the floor. It is impossible to say whether we are going to have votes or not. I think our likelihood is fairly good. If you could summarize. I have read both of your statements. If you could summarize your testimony, it would be very helpful to the Committee because we would like to ask some questions before we have to leave here.

And with that, Mr. Ewing, you may proceed.

STATEMENT OF A. HUGH EWING III, GENERAL PARTNER OF THE HILLCREST GROUP, RICHMOND, VA, ON BEHALF OF THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, ACCOMPANIED BY PETER McNEISH, PRESIDENT NASBIC

Mr. **Ewing**. Thank you, sir. I wonder if it might be all right with the Senator if we showed a film, a short clip that was on Financial News Network last night.

The **Chairman**. Yes. I would like to see it myself. I think I was on it.

Mr. **Ewing**. Yes, I think you were.

[A video was shown.]

Mr. **Ewing**. Thank you for your indulgence, Mr. Chairman. I appreciate the opportunity to testify today at the oversight hearing on the SBIC Program. I am Hugh Ewing, general partner of the Hillcrest Group of Richmond, VA. I am testifying today in my capacity as vice chairman of the National Association of Small Business Investment Companies (NASBIC), which is the national trade association for the SBIC industry. I am accompanied by Peter McNeish, president of the association. Due to the short notice provided, neither our chairman, Walter Wilkinson, nor our chairman-elect, David Croll, were able to attend today's hearing.

I have been associated with the SBIC industry for 9 years. Our company currently manages Crestar Capital, an SBIC with private capital of $9.1 million and leverage of $8.5 million. Our SBIC invests in small business with outstanding prospects for growth. Over the past 5 years, we have invested over $23 million in some 29 small firms.

Mr. Chairman, this series of oversight hearings has raised several important questions concerning the management of the SBIC Program and the health of the SBIC industry. And I intend to address those issues. At the outset, I would like to take a few minutes to put the issues in perspective and place several facts in the record.

First, it is important to understand the nature of our business. SBIC's are designed to finance nonbankable, high-risk ventures. Inherent in that concept is the fact that some of those investments may not be successful and there will be losses. A well-managed SBIC with sound investment standards, good timing and market conditions, and perhaps a little luck, will invest in winners that offset those losses, producing a net gain for the SBIC and its investors.

The program is designed so that private investors who put their money in an SBIC are in the primary risk position. They stand to lose all of their invested capital before the Government loses at all.

Even the most highly leveraged SBIC has private capital equal to at least 25 percent of its liabilities, and the ratio for most of the industry is even higher. This private capital cushion is far higher than that found in commercial banks or other financial institutions.

In the Committee's zeal to discover and correct what went wrong in the River Capital case, I would urge you not to lose sight of the positive results the SBIC Program has produced for the U.S. economy in terms of new company formations, job creation, innovations, and the generation of new tax revenues.

We must be careful that corrective measures do not put such a burden on SBIC's that the program is impractical and thereby loses the benefit it provides to small businesses.

Your letter of invitation noted several questions of interest to the committee, and I will now address these points. First, the overall health of the industry. The regular SBIC industry went through a wrenching decline during the last 5 years. From 1985 to 1989, the number of regular SBIC's declined by almost 40 percent, and the annual rate of small business financings dropped by 30 percent.

Since the early 1980's, we have operated in an environment which provided larger companies attractive alternatives and continually expanding access to venture capital, leveraged buy-out, and bank financing.

But these trends were not accompanied by similar opportunities for the types of small businesses served by SBIC's. Now, we see those trends changing dramatically. LBO's and bank financing have dried up. Venture capital is in shorter supply. It is not surprising that we now see rekindled interest in the SBIC Program. The cycle is changing. Pricing of SBIC investments is improving, resulting in improved performance prospects for investments made during this cycle. It is the right time to expand the SBIC Program.

This was evidenced last year when there was a significant increase in the number of new SBIC license applications. We attribute this turnaround in part to the new responsive attitude of the current Administration coupled with a major promotional campaign launched by our trade association to stimulate the formation of new SBIC's.

You inquired about the financial condition of SBIC's. Based on the aggregate data available and anecdotal information on individual companies, it appears that regular SBIC's are essentially sound. SBA's ratings of operating SBIC's confirm this conclusion, noting that 85 percent of those companies are in satisfactory or better condition.

The most recent financial data available for the industry on a composite basis is as of March 31, 1989. On that date, the 254 reporting SBIC's presented a very strong balance sheet. In aggregate, those SBIC's had total assets of $3.9 billion, total liabilities of $1.4 billion, and total capital of $2.5 billion. The industry's liabilities included $867 million in leverage from SBA. As you will note from that data, on an aggregate basis, the industry's debt-to-equity ratio is a very conservative 0.6 to 1.

Those SBIC's were also profitable in 1989. Every category of SBIC by ownership type showed a profit during the year. On an aggregate basis, the SBIC's produced an 8.3 percent return on capital and paid $56 million in taxes.

There are general observations, however, that can be made about some factors which can negatively affect SBIC's. The quality of an SBIC's investments depends in part on the skill, experience, and judgment of the SBIC's management.

The last 7 years have been a very poor economic environment for the small growth company market. The diversion of major corporations to merger and leverage transactions, and the disappearance of an IPO market have virtually eliminated liquidity opportunities for small growth companies.

At the same time, plentiful venture capital drove valuations up and returns down. As Senator Kasten mentioned, repeal of the capital gains tax exclusion was both a disincentive to the development of small growth companies and a negative financial factor for SBIC investors.

I would point to the series of dysfunctional SBA regulations that have had a negative impact on the industry, particularly those which have increased the operating costs of SBIC's and narrowed their capacity to earn profits.

As a concluding statement on SBIC defaults, I would again point out that SBIC's were intentionally designed to invest in small, but risky ventures. Some of those small firms will not make it, and SBIC's will have losses in their portfolio.

You also inquired about SBA recoveries and losses. I would like to reiterate a misconception from the prior hearings that should be corrected. On several occasions, the amounts of money involved in SBIC defaults were incorrectly perceived as losses incurred by the Government. In fact, SBA's actual losses from the SBIC Program have only been a small percentage of total defaults. SBA has provided $2.98 billion to the SBIC industry over the 32-year history of the company—excuse me, of the program. Of that amount, 44 percent has been repaid with interest, 37 percent is currently being used by active SBIC's. Only 2.5 percent or $75 million has been written off as a loss. The balance of $505 million, or 17 percent, is currently in liquidation, where SBA is seeking recoveries.

If you assume Mr. Crusto's number of $250 million as an estimate for perspective losses in the program from the beginning to what the SBA sees today, it would translate into an effective loss rate of 8.5 percent on the total $2.98 million extended to the industry throughout its history.

Since Apple Computer paid an estimated $259 million in taxes last year, just one SBIC investee company could be construed to recover the total projected losses of the entire SBIC industry over 32 years in just 1 year of its tax payments.

Turning to SBIC portfolio companies, during the past 32 years, SBIC's have invested $9.1 billion in 67,500 small businesses in all 50 United States. SBIC's invest in start-up firms, recapitalized mature businesses, and provide essential expansion financing for small growth companies. They finance diverse industries, such as small manufacturing and service operations, as well as high-tech firms. Highly successful name-brand SBIC investments include some of those shown on the tape: Federal Express, Apple Computer, Rolm Corp., Cray Research, and Intel Corp.

In our portfolio at Crestar Capital, we do not have such well-known names, although we hope to have them at some point in the future. Examples of recent investments by our firm include two companies in the Washington, DC area, ProScience Corp. of Sterling, VA, a developer and manufacturer of diagnostic tests to reduce disease in the dairy industry, and J.L. Wickham Co. of Baltimore, a developer and manufacturer of patented machining centers, which successfully competes with foreign manufacturers of the same types of equipment.

Both of these companies have excellent prospects and could not have developed to their current position without SBIC financing.

You have asked for our views on the present system of SBIC audits, and how that system might be improved. In considering this subject, it is important to make a clear distinction between financial audits on the one hand, and regulatory compliance audits on the other hand. Financial audits involve an audit of the financial books and records, and financial condition of an SBIC. This form of audit is performed by an independent CPA firm.

Regulatory compliance audits involve an audit of the transactional books and records of the SBIC, to determine that the SBIC has operated in compliance with SBA's regulations. The regulatory compliance audit is currently performed by the staff of the SBA Inspector General.

Financial reporting requirements for SBIC's are comprehensive and substantial. These requirements have been developed and revised on the basis of over 30 years experience with the SBIC Program. And they provide extensive data which SBA can use to monitor the financial condition and performance of each SBIC.

Mr. Chairman, as a result of the River Capital case, you have raised the legitimate question of whether the process by which SBIC portfolio investments are valued and audited is reliable. Determining the value of any closely held investment is a very subjective process that depends on the circumstances of each individual financing, and requires an informed assessment of several financial and nonfinancial considerations, such as management capacity, market depth, and product line breadth.

This also means that there is no single method for determining the fair value of a very diverse universe of SBIC investments. The accounting profession, a series of Government agencies, including the SEC and SBA, and the investment banking industry have long recognized that the responsibility for valuing portfolio securities in good faith should reside with the SBIC's board of directors or general partner.

At the same time, both AICPA and SBA guidelines make it clear that the independent auditor's role is not to second guess those valuations. Rather, the auditor's responsibility is to determine that the valuation process used by the board was reasonable and properly documented. The SBIC industry recognizes that this issue of valuations can be potentially disruptive for the industry unless it is resolved to the satisfaction of this Committee, and to the SBA. Consequently, I am pleased to announce today that the National Association of Small Business Investment Companies and the National Association of Investment Companies have jointly taken the initiative to develop a set of guidelines for the valuation of portfolio securities.

We have jointly submitted these proposed guidelines to SBA today, with our recommendation that they be adopted by the Agency and uniformly applied to the SBIC industry. A copy of the guidelines is included as an enclosure to my written statement, and we would welcome any questions or comments from Members of the Committee or staff.

These guidelines will not be without controversy within our own industry. They are far more detailed than many in the industry would prefer, and they set specific standards in an area that, by its very nature, is subjective. We feel confident that the adoption of these guidelines by SBA will remove the cloud over the issue of valuations and resolve the thorny issue raised by the River Capital situation.

As I noted earlier, regulatory compliance audits involve an independent third-party review of the SBIC's operations to assure that the SBIC is in compliance with SBA's regulations. Up until a year ago, or so, the compliance audit process was fairly simple, and responsibilities within SBA were well defined, and understood by Agency personnel and by the industry. The Inspector General's office provided an audit service, and the Investment Division had clear regulatory and enforcement authority.

The Inspector General now asserts that his office has the authority to determine if regulatory violations have occurred, and the authority to stipulate that corrective action should be taken. If this role reversal is allowed to take place, it will mean the Inspector General will be the regulatory authority in charge of the SBIC Program, and the Investment Division will be reduced to the role of a paper servicing functionary. This problem needs to be corrected.

The confusion in this process has been disruptive, has caused great uncertainty in the industry, and has resulted in audit completion and funding delays.

You have asked us for our assessment of the present management of the program, and the working relationship between our member companies and SBA. We are very encouraged by the current Administration's attitude, initiative, and responsiveness toward small business in general, and the SBIC Program in particular. Ms. Engeleiter and the rest of SBA's new management team have offered an open door and a sincere willingness to work with the industry in an effort to rebuild and improve the SBIC Program.

At the operating management level, we have consistently promoted increased resources for the Investment Division of SBA. The Investment Division has played a critical role in developing and administering the SBIC Program, but in recent years its staffing and capabilities have been significantly reduced. We believe both the amount and quality of the Investment Division's resource capability should be increased. In reality, the SBIC industry will benefit if the SBA is able to carry out its mission at a high quality level of performance. And the industry will suffer if the Agency performs at a lower level.

We have eight specific recommendations for improvement to the program.

1. The SBA should adopt and implement the guidelines for the valuation of portfolio securities we have today proposed for universal application to the SBIC industry.

2. We recommend the minimal capitalization for a newly licensed regular SBIC be raised to the level of at least $2 million. Industry experience relating to operating costs, profitability, size of investments, and other factors shows conclusively that very small SBIC's are often unsuccessful because of undercapitalization.

3. We recommend that SBA raise its minimum qualification standards for managers of SBIC's.

4. The SBA should implement the major regulatory changes we have recommended to the Agency. We have identified a series of current SBA regulations that are having a serious, dysfunctional effect on the ability of SBIC's to operate effectively in today's commercial markets. We have recommended specific and detailed changes in those regulations which should improve the performance of SBIC's, and enhance their capacity to finance small business.

5. The current statutory basis for SBIC access to fourth-tier leverage should be changed. Under existing law fourth-tier leverage is only available to SBIC's that have an investment portfolio that is comprised primarily of "venture"-type investments. This provision was put in the statute as an incentive to SBIC's to invest in more venture-type deals. However, it has not produced that result because it defies economic logic.

If an SBIC is highly leveraged, it will need substantial cash flow to meet its debt service requirements. An SBIC with a portfolio comprised primarily of venture capital-type investments, however, will normally produce insufficient cash flow to handle that kind of debt service requirement. Therefore, the statute should be amended so that fourth-tier leverage is available only to SBIC's that have at least 75 percent of their investments in the form of loans or debt securities. This change will allow such SBIC's to match their cash flow to the debt service requirement.

6. SBA should take any necessary action to reaffirm that the Investment Division has clear regulatory authority and responsibility over the SBIC Program, while the role of the Inspector General's Office is that of regulatory compliance and audit fact finding.

7. SBA should set up a streamlined process through which the portfolio securities of SBIC's placed in liquidation can be offered for purchase by operating SBIC's. We think this would help reduce the SBA's staffing requirements in working to liquidate the investments that are part of liquidating SBIC's portfolios.

8. SBA should increase both the level and quality of the Investment Division staff and resources in order to assure effective management of the SBIC Program.

We appreciate the opportunity to testify on these subjects of vital importance to the industry, and your indulgence to let me carry on for such an extended period of time. As you consider the problems and opportunities of the industry, please keep uppermost in your minds the benefits of job creation, tax generation, and innovation which far outweigh the historical and projected losses of the industry.

Thank you, Mr. Chairman. I would be happy to try to respond to any questions you have.

[The prepared statement of Mr. Ewing follows:]

NASBIC

August 2, 1990

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PETER F. McNEISH

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STATEMENT OF
A. HUGH EWING, III

Before the
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Good morning! I appreciate the opportunity to testify today at this oversight hearing on the SBIC program.

I am Hugh Ewing, General Partner of the Hillcrest Group, which is located in Richmond, VA. I am testifying today in my capacity as Vice-Chairman of the National Association of Small Business Investment Companies (NASBIC), which is the national trade association for the SBIC industry. I am accompanied by Peter McNeish, President of the association. Due to the short notice provided, neither our Chairman, Walter Wilkinson, nor our Chairman-Elect, David Croll, were able to attend today's hearing.

I have been associated with the SBIC industry for 9 years. Our company currently manages Crestar Capital, L.P., an SBIC with private capital of $9.1 million, and leverage of $8.5 million. Our SBIC invests in small businesses with outstanding prospects for growth. Over the past 5 years, we have invested over $23 million in some 29 small growth firms.

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
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THE ISSUES IN PERSPECTIVE

Mr. Chairman, this series of oversight hearings has raised several important questions concerning the management of the SBIC program and the health of the SBIC industry, and I intend to address those issues.

At the same time, however, misleading press coverage of the hearings has had the unintended effect of causing substantial damage to the program and bringing into question the very future of the SBIC industry.

So, at the outset I would like to take a few minutes to put the issues in perspective and place several facts in the record.

- **SBICs Finance Risky Ventures** - First, it is important to understand the nature of our business. SBICs are designed to finance non-bankable high-risk ventures. Inherent in that concept is the fact that some of those investments may not be successful - and there will be losses. A well-managed SBIC, with sound investment standards, good timing and market conditions - and perhaps a little luck - will invest in winners that offset those losses, producing a net gain for the SBIC and its investors.

- **Private Capital At Risk** - The program is designed so that private investors who put their money in an SBIC are in the primary risk position. They stand to lose all of their invested capital before the government takes a loss. Even the most highly leveraged SBIC has private capital equal to at least 25% of its liabilities, and the ratio for most of the industry is even higher. This private capital cushion is far higher than that found in commercial banks or other financial institutions.

- **Benefits Produced** - In the Committee's zeal to discover and correct what went wrong in the River Capital case, I would urge you not lose sight of the positive results the SBIC program has produced for the U.S. economy in terms of new company formations, job creation, innovations and the generation of new tax revenues.

  We've testified previously about the numerous benefits the SBIC program has produced, so I will not take the Committee's time by reiterating those achievements. I will be pleased to submit that information for the record.

  Let me simply state, in summary, that benefits the program has produced far outweigh any losses the government has realized to date or is projected to realize in the future.

- **The Royal and River Cases** - I would also urge the Committee not to indict the total SBIC industry because of two unusual SBIC cases that developed ten years apart.

  Royal Business Funds - The issues in question in the Royal case relate to a unique and highly unusual liquidation management practice inside SBA, that is, the Agency's management of the SBIC's assets over the 10 year period after the SBIC went into liquidation.

  We have no comment on that case, except to give credit to the SBA Administrator for taking decisive action to correct the situation and to assure such practices will not be repeated.

River Capital - We have not had access to any of the reports on River Capital, and we have no first hand knowledge of the specific facts in the case. Consequently, we are not in a position to either defend or criticize that company or its management, or to comment on its investment portfolio.

I would make a few general observations, however, based on information provided at the previous hearings. First, it would be highly unusual for an SBIC - particularly one with a large, diversified investment portfolio - to literally collapse overnight. Normally, individual companies in an SBIC's investment portfolio will deteriorate over time, and there should be adequate warning signs both for the SBIC's management and SBA.

The key question then is why SBA's monitoring system allowed the Agency to continue to pump leverage into that company over a four to five year period of time without identifying the deteriorating condition of the SBIC and its portfolio. That monitoring system included several audits by the SBA Inspector General's office and reviews of the SBIC's financials by the Investment Division, both annually and prior to each leverage drawdown.

We understand SBA has taken steps to improve the process by which it monitors the financial condition and performance of SBICs, and we support any reasonable actions along those lines. As investors, we have a responsibility to monitor the performance of our portfolio companies, and SBA has a parallel responsibility with its portfolio of SBICs.

o **Misleading Press Coverage** - One regretable spin-off of these hearings has been a series of misleading and incorrect stories in the press that have unfairly damaged the SBIC industry. I have included as an attachment to my written statement a copy of our association's letter to the Editor of Business Week in an attempt to clarify the record.

- **Moratorium on Licensing** - Another spin-off of the hearings has been SBA's imposition of a 90-day maratorium on the licensing of new SBICs. We strongly opposed a moratorium as a counterproductive action which was particularly unfair to the 37 applicants who were in the application process, and a damaging setback that hurt both the industry and small business. For the record, I have also attached to my testimony a copy of our letter to the SBA Administrator stating our position on the moratorium.

POINTS OF INTEREST TO THE COMMITTEE

Your letter of invitation noted several questions of interest to the Committee, and I will now address those points.

Overall Health of the Industry

Dramatic Decline - The regular SBIC industry went through a wrenching decline during the last five years, from 1985-89, as shown by the following table:

	Active SBICs	# of Small Businesses Financed
1985	372	2,756
1986	333	2,675
1987	307	2,522
1988	285	2,227
1989	263	1,876

The number of regular SBICs today is almost 40% lower than it was five years ago, and the annual rate of small business financings has dropped by 30%.

Since the early 1980's we have operated in an environment which provided larger companies attractive alternatives and continually expanding access to venture capital, leveraged buyout and bank financing. But these trends were not accompanied by similar opportunities for the types of small businesses served by SBICs.

Now we see those trends changing dramatically. LBOs and bank financing have dried up. Venture capital is in shorter supply. It is not surprising that we now see rekindled interest in the SBIC program. The cycle is changing. Pricing of SBIC investments should improve, resulting in improved performance of investments made during this cycle. This is the right time to expand the SBIC program.

Another factor in the industry's decline was the prior Administration's attempt to close down the SBA and terminate the SBIC program, and a series of regulations which had a dysfunctional effect on the program. Those actions effectively caused people to withdraw from the program and closed down the pipeline of new SBIC license applications, which historically have exceeded the loss of SBICs due to voluntary license surrenders or defaults.

This trend began to reverse itself late last year when there was a significant increase in the number of new SBIC license applications. As of June 30, 1990, there were 266 SBICs in the program.

We attribute this turnaround, in part, to the new, responsive attitude of the current Administration, coupled with a major promotional campaign launched by our trade association to stimulate the formation of new SBICs. Regretably, that renewed growth pattern has been severely curtailed as a result of the negative press coverage of these hearings and the moratorium on licensing.

Financial Condition - Based on the aggregate data available, and anecdotal information on individual companies, it appears that the remaining core group of regular SBICs is, for the most part, essentially sound. SBA's ratings of operating SBICs confirm this conclusion, noting that 85% of those companies are in satisfactory or better condition.

The most recent financial data available for the SBIC industry on a composite basis is as of March 31, 1989. On that date, the 254 reporting SBICs presented a very strong balance sheet. In aggregate, those SBICs had total assets of $3.9 billion; total liabilities of $1.4 billion; and total capital of $2.5 billion. The industry's liabilities included $867 million in leverage from SBA. As you'll note from that data, on an aggregate basis the industry's debt to equity ratio is a very conservative 0.6:1.

Those SBICs were also profitable in 1989. Every category of SBIC, by ownership type, showed a profit during the year. On an aggregate basis, the 254 SBICs produced an 8.32% return on capital, and paid $56.2 million in taxes.

We do not, of course, have access to the financial records of individual SBICs, so we have no way of verifying the financial condition of individual companies. In that regard, we will be as interested as the Committee in learning the results of the SBA Inspector General's current review of the 50 plus SBICs with significant amounts of outstanding leverage.

SBIC Defaults - The Committee has correctly expressed concern over the increased rate of SBIC defaults over the past several years.

There are several routes of departure from the SBIC program. A number of SBICs voluntarily leave the program each year for business reasons and surrender their license. An SBIC's license can be revoked - normally for serious violations of the regulations.

Finally, an SBIC can be removed from the program and placed in "liquidation status:" (a) because of capital impairment, which occurs when losses from bad investments cause an SBIC's private capital to diminish by 50% or more; or (b) for defaulting on payments of principal or interest owed to SBA.

Since the program's inception in 1958, SBA has licensed 1,605 SBICs. Currently, 401 of those SBICs (25%) remain actively operating companies. Over the 32-year life of the program, 728 SBICs (45%) have volutarily surrendered their licenses; 7 licenses (0.4%) have been revoked; and 463 companies (29%) have been placed in liquidation by SBA. Once an SBIC is placed in liquidation, SBA takes action to recover its money by liquidating the SBIC's assets.

The causes of SBIC defaults are directly related to the risk and performance of the individual portfolio companies in an SBIC's investment portfolio, and the timing of that performance. Consequently, the causes are both varied and complex. It is a gross oversimplification to simply use 20-20 hindsight and say the SBIC made "bad" investments.

To the best of our knowledge, no one has ever studied the underlying reasons for SBIC defaults, including a comprehensive analysis of the performance of their portfolio companies. Certainly, every SBIC manager believes each deal he or she puts on the books is "money good" at the time of the investment.

There are general observations, however, that can be made about some factors which can negatively affect SBICs:

o The quality of an SBIC's investment depends, in part, on the skill, experience and judgment of the SBIC's management. This observation relates to a point I will make on licensing standards later in my testimony.

o The slow-down in the high tech sector of the economy certainly had a negative effect, narrowing investment opportunities and pushing out smaller, marginal companies.

o The last seven years have been a very poor economic environment for the small growth company market. The diversion of major corporations to merger and leverage transactions, and the disappearance of an IPO market have virtually eliminated liquidity opportunities for small growth companies. At the same time, plentiful venture capital drove valuations up and returns down.

o Repeal of the capital gains tax exclusion was both a disincentive to the development of small growth companies, and a negative financial factor for SBIC investors.

o Finally, I would point to the series of dysfunctional SBA regulations that have had a negative impact on the industry, particularly those which have increased the operating costs of SBICs and narrowed their capacity to earn profits.

As a concluding statement on SBIC defaults, I would again point out that SBICs were intentionally designed to invest in small, but risky business ventures. Some of those small firms won't make it, and SBICs will have losses in their portfolios.

SBA Recoveries and Losses - There is one apparent misconception from the prior hearings that should be corrected. On several occasions the amounts of money involved in SBIC defaults were incorrectly perceived as "losses" incurred by the government. In fact, SBA's actual losses from the SBIC program have only been a small percentage of total defaults.

SBA has provided $2.98 billion to the SBIC industry over the 32-year history of the program. Of that amount:

- $1.3 billion (44%) has been repaid, with interest

- $1.1 billion (37%) is currently being used by active SBICs.

- $75 million (2.5%) has been written off as a loss.

- The balance of $505 million (17%) is currently in liquidation, where SBA is seeking recoveries.

When an SBIC goes into liquidation, its private investors lose all their invested capital first, providing a buffer against government losses. In addition, many SBICs, prior to going into liquidation, have made a number of successful investments and those assets have substantial liquidation value.

Over the life of the program, 463 SBICs (29%) have gone into liquidation. SBA has completed liquidation action on 306 SBICs which owed SBA $214 million. SBA recovered $139 million from the sale of those SBIC's assets, a recovery rate of 65%.

SBA has charged off only $75 million in losses. In percentage terms, this means that SBA's acutal realized loss rate on the $2.98 billion it has provided to the industry is only 2.5%.

The remaining 157 SBICs currently in liquidation owe SBA $505 million. If SBA's recovery rate experience is applied to this debt, it will produce recoveries of $328 million and losses of $177 million. On a projected basis, SBA's aggregate losses on all SBICs placed in liquidation would be $252 million.

That would translate to an effective loss rate of 8.5% on the total $2.98 billion extended to the industry.

Since Apple Computer paid $259 million in taxes last year, just one SBIC investee company could be contrued to recover the total projected losses of the entire SBIC industry over 32 years.

SBIC Portfolio Companies - During the past 32 years, SBICs have invested $9.1 billion in 67,500 small businesses in all 50 states.

SBICs invest in start-up firms, recapitalize mature businesses and provide essential expansion financing for small growth companies. They finance diverse industries such as small manufacturing and service operations as well as high tech firms.

Highly successful "name brand" SBIC investments include Federal Express, Apple Computer, Rolm Corporation, Cray Research and Intel Corp.

Our portfolio does not contain such well known names, although we hope that some of our companies will be equally successful. Examples of recent investments include two companies in the Washington, DC area: ProScience Corporation of Sterling, Virginia, a developer and manufacturer of diagnostic tests to reduce disease in the dairy industry, and J.L. Wickham Company of Baltimore, Maryland, a developer and manufacturer of patented machining centers which successfully competes with foreign manufactures.

Both of these companies have excellent prospects and couldn't have developed to their current position without SBIC financing.

Audits of SBICs

You have ask for our views on the present system of SBIC audits, and how that system might be improved. In considering this subject, it is very important to make a clear distinction between financial audits on the one hand, and regulatory compliance audits on the other.

Financial audits involve an audit of the financial books and records and financial condition of an SBIC. This form of audit is performed by independent CPA firms.

Regulatory compliance audits involve an audit of the transactional books and records of the SBIC to determine that the SBIC has operated in compliance with SBA's regulations. The regulatory compliance audit is currently performed by the staff of the SBA Inspector General.

The SBIC Financial Audit - As a material part of SBA's responsibility to monitor the financial condition and performance of SBICs, each SBIC is required to submit an audited financial statement to the Agency on an annual basis, or more often if specifically required by SBA.

In addition to complying with AICPA standards, SBICs are required to comply with a comprehensive set of audit standards prescribed by SBA that are specifically tailored for SBICs. They are also required to use a special chart of accounts designed for SBICs and financial reporting forms prescribed by SBA.

To give you some idea of how detailed and comprehensive these requirements are, they take up 86 pages of fine print in the "U.S. Code of Federal Regulations."

In summary, the financial reporting requirements for SBICs are comprehensive and substantial. These requirements have been developed and revised on the basis of over 30 years experience with the SBIC program, and they provide extensive data which SBA can use to monitor the financial condition and performance of each SBIC.

Valuation of Portfolio Securities - The prior hearings have made it clear, however, that even this extensive financial information is not sufficient to give this Committee or the SBA adequate comfort concerning the risk profile of individual SBICs or the industry as a whole.

Mr. Chairman, as a result of the River Capital case you have raised the specific question of whether the process by which SBIC portfolio investments are valued and audited is reliable. It's a very legitimate issue, Mr. Chairman, and it bears a direct relationship to your concern with the overall health of the SBIC industry and the government's potential exposure to losses.

Let me first make some general comments about the valuation of SBIC portfolio investments. SBIC investments are generally venture-type investments in closely held, non-mature small firms whose stock has no public or private trading market. SBIC investments are not listed stocks, over-the-counter stocks or even pink sheet stocks.

As a result, determining the value of each investment is a very subjective process that depends on the circumstances of each individual financing, and requires an informed assessment of several non-financial considerations such as management capacity, market depth and product line breadth. This also means that there is no single method for determining the fair value of a very diverse universe of SBIC investments.

The accounting profession, a series of government agencies (including SEC and SBA) and the investment banking industry have long recognized that the responsibility for valuing portfolio securities in good faith should reside with the SBIC's Board of Directors or General Partner(s).

At the same time, both AICPA's and SBA's guidelines make it clear that the independent auditor's role is not to second-guess those valuations. Rather, the auditor's responsibility is to determine that the valuation process used by the Board was reasonable and properly documented.

This process has worked well for over 30 years - until River Capital. Now it appears that while the basic concepts underlying the valuation process are sound and should be retained, the latitude allowed by the process does not provide the government sufficient comfort or certainty.

The SBIC industry recognizes that this issue of valuations is a reality that can be potentially disruptive for the industry unless it is resolved to the satisfaction of this Committee and the SBA.

Consequently, I am pleased to announce today that the National Association of Small Business Investment Companies (NASBIC) and the National Association of Investment Companies (NAIC) have jointly taken the initiative to develop a set of "Guidelines for the Valuation of Portfolio Securities."

We've worked very hard on a joint-venture basis to develop these guidelines, Mr. Chairman. We assembled some of the best talent an brainpower in both the regular and specialized SBIC industries in a series of meetings over the last two months to hammer our specific standards for valuations.

We have jointly submitted these proposed guidelines to SBA today, with our recommendation that they be adopted by the Agency and uniformly applied to the SBIC industry.

A copy of the Guidelines is included as an enclosure to my written statement, and we would welcome any questions or comments from members of the Committee or staff.

These guidelines will not be without controversy within our own industry. They are far more detailed than many in the industry would prefer, and they set specific standards in an area that by its very nature is subjective.

In designing the guidelines, we had a threefold objective. First, we felt it was important to establish a conservative basis for establishing fair value of portfolio securities. Second, we wanted to develop a set of consistent valuation standards that the government can rely on. And, finally, we wanted to provide the certainty of a uniform audit process to verify the reasonableness of the licensee's valuations.

We feel confident that the adoption of these Guidelines by SBA will remove the cloud over the issue of valuations, and resolve the thorny issue raised by the River Capital situation.

Regulatory Compliance Audits of SBICs.

As I noted earlier, regulatory compliance audits involve an independent third-party review of the SBIC's operations to assure that the SBIC is in compliance with SBA's regulations. This type of audit includes everything from the mundane (is the SBIC license hanging on the wall?) to the sublime (does a complex financing involving several investment companies comply with the conflict of interest restrictions?). But, it has nothing to do with the value of an SBIC's portfolio or the financial condition of the SBIC.

Up until a year or so ago, the compliance audit process was fairly simple and responsibilities within SBA were well defined and understood by Agency personnel and by the industry. The IG's office provided an audit service, and the Investment Division had clear regulatory and enforcement authority.

Audit staff from the Inspector General's office conducted the on-site regulatory compliance audit of the SBIC and wrote an audit report which contained "findings of alleged regulatory violations" (if any). After review by the IG's central office staff, that report was sent to the Investment Division of SBA.

The Investment Division had the clear responsibility to review the report, determine if the findings of alleged violations were correct, seek additional information from the SBIC if necessary, and initiate and enforce any required corrective action. In short, the Investment Division had clear regulatory authority. Within the past year, this process has become very confused, and seemingly has been stood on its head. It appears that the

Inspector General now asserts that his office has the authority to determine if regulatory violations have occurred, and the authority to stipulate what corrective action should be taken.

If this role reversal is allowed to take place, it will mean the Inspector General will be the regulatory authority in charge of the SBIC program, and the Investment Division will be reduced to the role of a paper servicing functionary.

This problem needs to be corrected. The confusion in this process has been disruptive, has caused great uncertainty in the SBIC industry and has resulted in audit completion and funding delays.

Applying Government Auditing Standards (GAGAS Audits) to SBICs

Now, on top of the confusion noted above, the Inspector General has proposed the application of GAGAS audits to SBICs.

We have substantial problems with that proposal, Mr. Chairman.

We question the applicability of this type of audit to investment companies. As we understand GAGAS audits, they were designed primarily for the audit of governmental units that receive federal funds and organizations that operate Federal grant programs.

In addition, it seems clear that the application of GAGAS-type audits to SBICs would be duplicative of the regulatory compliance audits now conducted by the Inspector General.

GAGAS audits appear to have three primary components, namely:

1. They incorporate the AICPA standards of reporting for financial audits. For SBICs, this is what is currently being done by independent CPA firms, so it represents no change from the present system.

2. They add an audit component which covers "compliance with applicable laws and regulations." This is the exact function currently being performed by the Inspector General's audit staff. Requiring CPA firms to also do regulatory compliance audits would result in an unnecessary and costly duplication of effort.

3. They add an component which audits the performance of the company, i.e. whether the organization has achieved the desired results of the program. This element seems specifically designed for Federal grant programs and does not seem applicable to the SBIC program.

Finally, we are seriously concerned with the very practical consideration of cost. It seems clear that if independent CPA firms were required to conduct full-blown GAGAS audits of SBICs the cost would be enormous, and the results would be the same as those now produced under the current system.

We would be pleased to work with SBA management and the Inspector General to see if some form of audit system could be developed which would focus on the so-called "Big 6" regulatory violations. We can fully understand the Inspector General's desire to contract-out (or delegate) the SBIC regulatory compliance audit function to independent CPA firms and thereby free-up his limited staff and resources for other important audit functions within the Agency. However, we would need to resolve the very serious questions of audit scope, duplication and cost.

SBA's Management of the Program and the Relationship Between SBICs and the SBA

You've ask us for our assessment of the present management of the program and the working relationship between our member companies and SBA.

Obviously, Mr. Chairman, this is a delicate subject for a regulated industry to address.

As you know, the Agency has just launched a major review of the program looking toward possible structural, regulatory and legislative changes. So, I'm sure you can appreciate our position that it is not the time to throw bombs at the Agency.

There is always a reasonable degree of friction between a governmental regulatory agency and the industry it regulates. This is certainly true for the SBIC program. Clearly, that friction level was at its peak during the prior Administration when attempts were made to close down or seriously cripple the program.

We are very encouraged by the current Administration's attitude, initiative and responsiveness toward small business in general, and the SBIC program in particular.

Ms. Engeleiter and the rest of SBA's new management team have offered an open door and a sincere willingness to work with the industry in an effort to rebuild and improve the SBIC program.

At the operating management level, we have consistently promoted increased resources for the Investment Division of SBA. The Investment Division has played a critical role in developing and administering the SBIC program, but in recent years its staffing and capabilities have been significantly reduced.

We believe both the amount and quality of the Investment's Division's resource capabilities should be increased. In reality, the SBIC industry will benefit if the SBA is able to carry out its mission at a high quality level of performance, and the industry will suffer if the Agency performs at a lower level.

Otherwise, it is premature at this time to comment on the operating level management of the program. Some management changes have recently been made, interim management is now in place and we understand that the possibility of adding additional staff is now being considered.

Recommendations for Improvement in the Program

We do have a series of specific recommendations to improve the program.

1. The SBA should adopt and implement the "Guidelines for the Valuation of Portfolio Securities" we have today proposed for universal application to the SBIC industry.

2. We recommend that the minimum capitalization for a newly licensed regular SBICs be raised to the level of at least $2.0 million.

Industry experience relating to operating costs, profitability, size of investments and other factors shows conclusively that very small SBICs are often unsuccessful because of undercapitalization.

This change should produce a significant side benefit for the program, as more substantially capitalized SBICs will be able to attract more experienced and better qualified managers.

3. We recommend that SBA raise its minimum qualification standards for managers of SBICs.

   SBA's current qualification requirements reflect an absolute bare-bones minimum standard that should be raised. Better quality managers should enhance the performance and profitability potential of SBICs.

4. The SBA should adopt and implement the "Guidelines for Valuation of Portfolio Companies" we have proposed for universal application to the SBIC industry.

5. The SBA should implement the major regulatory changes we have recommended to the Agency.

   We have identified a series of current SBA regulations that are having a serious dysfunctional affect on the ability of SBICs to operate effectively in today's commercial markets. We have recommended specific and detailed changes in those regulations which should improve the performance of SBICs and enhance their capacity to finance small business.

6. The current statutory basis for SBIC access to 4th tier leverage should be changed.

   Under existing law, 4th tier leverage is only available to SBICs that have an investment portfolio that is comprised primarily of "venture" type investments. This provision was put in the statute as an incentive to SBICs to invest in more venture-type deals. However, it has not produced that result because it defies economic logic. If an SBIC is highly leveraged it will need substantial cash flow to meet its debt service requirements. An SBIC with a portfolio comprised primarily of venture-type investments, however, will normally produce insufficient cash flow to handle that kind of debt service requirement.

The statute should be amended so that 4th tier leverage is available only to SBICs that have at least 75% of their investments in the form of loans or debt securities. This change will allow such SBICs to match their cash flow to their debt service requirement.

7. SBA should take any necessary action to reaffirm that the Investment Division has clear regulatory authority and responsibility over the SBIC program, while the role of the Inspector General's office is that of regulatory compliance audit fact-finding.

8. SBA should set up a streamlined process through which the protfolio securities of SBICs placed in liquidation can be offered to operating SBICs.

9. SBA should increase both the level and quality of the Investment Division staff and resources in order to assure effective management of the SBIC program.

We appreciate the opportunity to testify on these subjects of vital importance to the industry.

NASBIC

June 4, 1990

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PETER F. McNEISH

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*Executive Committee

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Dear Sir:

Our industry has been a strong supporter of your coverage of small business issues. Unfortunately, your article on Small Business Investment Companies ("The Iran-Contra Scandal of the Small Business World," Small Business, June 4) is irresponsible journalism that has unfairly damaged a sound financial program important to small business.

Your article paints the SBIC industry as a good program that has gone bad, has outlived its usefulness, is mired in defaults and may be closed down by Congress. That portrayal is totally unfounded, based on factual errors, half-truths, misleading innuendo and wrong conclusions.

The SBIC program continues to have a positive record of building small companies. Congress is quite aware of the outstanding results achieved by the SBIC industry, and has no intention of terminating the program.

The assertion in the article that the "market is sending signals that the program may have outlived its usefulness" is completely at odds with reality. In today's credit crunch climate, banks and other conventional sources of capital have become risk-averse to small business, making venture financing by SBICs for small growth companies more essential than ever.

The truth is that SBICs have provided over $9.0 billion in critically needed venture capital to over 60,000 small growth companies. Certainly, we're proud of our outstanding successes - home runs like Federal Express and Apple Computer. But even more important, we continue to provide capital to a broad array of less spectacular - but equally essential - small businesses that fuel the American economy. These are the singles, doubles and triples by successful, growing companies that produce jobs, innovations and new products and pay taxes.

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The implication in your article that SBICs are similar to "hemorrhaging thrifts" that were thinly capitalized and poorly managed is a gross distortion. Every SBIC has a private capital base equal to at least 25% of its assets, and in most cases far higher. Currently, the 401 SBICs in the program have private capital of $1.9 billion, which far exceeds the $1.2 billion of government-backed loans outstanding.

It is true that the rate of SBIC defaults has increased over the past five years. That fact should not be surprising for a high-risk investment business in the context of an economy that has seen many segments of the financial markets experiencing difficulties. However, even here the picture your article paints is distorted. According to official SBA statistics, 160 SBICs are currently in default with loans of $486 million (not the $563 million figure cited in your article). More important, that is a cumulative figure aggregated over an extended period of years - dating back to the 1960s. Over that same period 1,500 SBICs have been licensed and $3.0 billion has been loaned to them. Therefore, only 11% of all SBICs and 16% of all funds loaned to SBICs are currently in default - percentages we find quite defensible for a high-risk venture investment program.

Your article incorrectly suggests that a default means the SBIC has been a total failure and the government stands to lose all funds loaned to that company. In fact, many SBICs, prior to going into liquidation, have made a substantial number of successful investments, and many of those assets have substantial value. Moreover, the major losers when an SBIC defaults are the private investors who lose all their invested capital before Uncle Sam loses one dime. Because private dollars buffer the government from losses, and the SBA has been able to realize value from the assets of defaulted SBICs, the government's actual rate of recovery on SBIC defaults has been 68.7% and its net realized loss from the SBIC program has been less than 2%.

Your article incorrectly implies that the government will have to come up with hundreds of millions of dollars to pay for losses on SBIC defaults, similar to the S&L bailout. In fact, the program was designed to anticipate losses because of its high-risk nature. SBA has provided an annual reserve for losses for the past 32 years. The reserve fund is more than sufficient to cover all projected losses from the program, and additional taxpayer dollars to cover losses will not be required.

The article incorrectly asserts that large hidden losses in the program will soon emerge, claiming that 20% of the operating SBICs are "candidates for failure." In fact, SBA's rating of operating SBICs has determined that only 4% of currently operating SBICs are in an unsatisfactory status. The article also lifts a quote from a consultant's report out of its proper context to suggest that the default trend was moving from a "critical to melt down stage." In fact, that quote did not refer to default trends. Rather, it characterized SBA's understaffing and insufficient resources to manage assets in liquidation.

Your article incorrectly states that budget cuts forced the SBA to cut back its annual audits of SBICs to every other year. In fact, budget cuts had nothing to do with the change to biennual audits. Congress changed the statutory annual audit requirement at the agency's request because the Inspector General of SBA found that 70% of the annual SBIC audits contained no adverse findings and were an inefficient use of his resources.

Your article incorrectly claims that fear of government cuts in funding have discouraged the formation of new SBICs. In fact, Congress has consistently provided adequate funding for the program. The drop in SBIC licensing over the past five years is directly attributable to the Reagan Administration's proposal to close the SBA and terminate the SBIC program. These actions created enormous uncertainty and discouraged potential investors from forming SBICs. With the Bush Administration's support for the program, that trend has now been reversed, with 19 new SBIC licenses issues so far in 1990, an additional 35 license applications pending and a resurgence of interest in the program.

Your article incorrectly cites the Royal Business Funds case as evidence that the program has too few safeguards. In fact, the Royal case had nothing to do with program safeguards or regulations. That case dealt with SBA's management of the company's assets years after it was placed in liquidation.

Finally, your article gives the misleading impression that a recent rash of SBIC defaults have suddenly created a crisis atmosphere in Washington. In fact, we're looking at defaults that evolved over a 10-year period, with the Royal liquidation in 1981 and River Capital in 1989; there is no crisis; and neither Congress nor the Administration is overreacting.

Your article completely neglected the positive side of the SBIC story. SBICs have successfully financed small, high-risk growth companies for over 30 years. The impact of those investments on our economy have been enormous - creating jobs, producing new products and technologies, generating additional tax revenues, enhancing the U.S. competitive position and fostering the entrepreneurial spirit in America. That's the story that should be told.

Your magazine has a powerful influence on American business, and it is truly regretable that your irresponsible article may cause many investors not to invest in SBICs. You have unfairly damaged our industry in the eyes of the business community and Washington policymakers, and in the process you have hurt small business.

Peter F. McNeish, President
National Association of
Small Business Investment Companies
Washington, DC

NASBIC

June 28, 1990

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PETER F. McNEISH

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*Executive Committee

Ms. Susan S. Engeleiter, Administator
U.S. Small Business Administration
1441 L Street, N.W., Room 1000
Washington, DC 20416

Dear Susan:

For the record, please be advised that the Officers and Board of NASBIC very much regret your action in imposing a 90-day moratorium on SBIC licensing.

While we recognize the pressures for this action, we believe the imposition of a moratorium on licensing is wrong for the following reasons:

o It has no relationship to the issues raised by the Senate hearings; namely, the government's potential exposure to loss from relying on the current system of SBIC portfolio asset valuation and audit.

o It is patently unfair to the 37 candidates for an SBIC license who have already filed an application. In addition to the expenditure of time, effort and money, these organizations and individuals have expended significant amounts of good will in securing commitments of private capital for their SBICs.

o It is particularly unfair to those applicants who have been in the slow, cumbersome application process for months and were on the verge of having their license approved by SBA. We have been advised by several of those applicants that the moratorium may cause their investors to withdraw their commitments of capital.

o Even more important, the moratorium sends a very damaging negative signal to both the domestic and foreign capital markets that the Federal government is an uncertain partner in a long-term investment program that requires stability. This is particularly true for the dozens of groups currently in the early stages of organizing SBICs. The moratorium is a major set-back for our association's promotional efforts to rebuild the industry and attract fresh new capital into SBICs.

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
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o Finally, the moratorium will hurt small business. The current environment for small business access to capital is quickly deteriorating. Small business needs more SBICs now, not fewer. Small business will be denied access to as much as $80 million of investment capital during the moratorium, and some of those funds may be withdrawn from the program forever.

At the same time, we share your desire to properly evaluate and correct any real weaknesses that may exist in the program, and to "create a stronger, more efficient, more effective SBIC program."

The leadership of our industry is prepared to make a postive contribution to improving the program. We openly offer our complete cooperation to you and your staff as you proceed with the process of evaluating administrative, regulatory and legislative changes in the program.

Sincerely yours,

Peter F. McNeish
President

cc: Kay Bulow
Sally Narey
Mitch Crusto
Berky Kulik
Joe Newell

John Ball
Don Terry

GUIDELINES FOR THE VALUATION OF PORTFOLIO SECURITIES

Objective - These guidelines are intended to provide (1) a conservative basis for establishing the fair value of portfolio securities held by licensees, (2) a set of consistent valuation standards which can be relied upon by the licensee's investors and the government, and (3) a uniform audit process to verify the reasonableness of the licensee's valuations.

Responsibility - The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith. It is incumbent upon the Board of Directors or General Partner(s) to satisfy themselves that all appropriate factors relevant to fair value have been considered and the method used to establish fair value is reasonable and prudent.

Methodology - No single method for determining value in good faith can be established, since fair value depends upon the circumstances of each individual financing and investments by licensees are generally venture-type investments in closely held, non-mature small firms whose stock is not publicly traded. Acceptable valuation methods may be based, for example, on the financial condition and/or earnings capacity of the small concern, a multiple of earnings, a discount from or a premium higher than the market price of a similar security that is freely traded, a yield to maturity for debt securities, or on a combination of those or other factors. All relevant factors should be considered in selecting the method of establishing the fair value of each portfolio security.

Procedure - The Board or General Partner(s) may appoint management or other individuals to assist in the valuation process, to provide supporting data and to make necessary calculations.

Documentation

(1) Each licensee shall develop and maintain a written statement, approved by the Board or General Partner(s), of its valuation policy and procedures.

(2) Each valuation decision should be set forth in the minutes of the Board/Partner(s) meeting.

(3) Each licensee shall prepare and retain in its files a valuation report for the valuation of each portfolio security which documents the factors, methodology, supporting data and calculations used to establish value.

(4) Licensees shall obtain current financial statements from each portfolio concern at least annually, except as noted below. Such financial statements may be unaudited, but shall include a statement of assets and liabilities and a profit and loss statement. Where production of financial statements would cause undue hardship to the small concern or financial statements are not essential to valuation of the portfolio security, the Licensee shall obtain a copy of the small concern's most recent Federal income tax return.

Frequency - Portfolio securities should be valued at least annually as of the close of the licensee's fiscal year, or more frequently where deemed necessary by the Board or General Partner(s).

Minimum Standards for Valuations - Each licensee should apply the following minimum standards to the valuation of its portfolio securities, and all valuation adjustments should be disclosed in the licensee's valuation report for the affected portfolio concern:

Securities of Private Companies

1. Investment cost is presumed to represent value except as indicated otherwise in these standards.

2. Valuation should be reduced if the portfolio company's performance and potential have significantly deteriorated.

3. Valuation should be adjusted to equate to a subsequent significant equity financing that includes a sophisticated, unrelated new investor. A subsequent significant equity financing that includes substantially the same group of investors as the prior financing should generally not be the basis for an adjustment in valuation.

4. Valuation may be adjusted if the company has been self financing for at least two years and has been cash flow positive for at least one year. The adjustment should be based on P/E ratios, cash flow multiples or other appropriate financial measures of similar companies. The valuation should be discounted by an appropriate percentage for illiquidity, unless liquidity is provided for through redemption or registration rights.

5. Warrants and options should be valued at the excess of the value of the underlying security over the exercise price.

6. Valuation of convertible debt should be adjusted to reflect the value of the underlying security net of the conversion price.

7. Valuation of collateralized securities should include consideration of the value of the underlying collateral, and appropriate adjustments should be made for changes in the value of that collateral.

8. The carrying value of interest bearing securities should not be adjusted for changes in interest rates.

9. Valuation of interest receivables on interest bearing securities should reflect the portfolio concern's financial condition, its payment history and its ability to generate sufficient cash flow to make interest payments. Past due interest should not be valued or converted to a security with carrying value if: (a) interest payments are in default more than six (6) months; (b) the ability of the company to make payments is considered doubtful; and (c) the interest bearing securities do not have a substantial underlying equity value as determined by the above criteria.

Securities of Public Companies

1. Publicly traded securities should be valued at the closing price or bid price except as indicated otherwise in these standards.

2. The valuation of public company securities that are restricted should be discounted appropriately until the securities may be freely traded.

3. When the number of shares of publicly traded securities held by the licensee is substantial in relation to the usual quarterly trading volume, the valuation should be discounted by an appropriate percentage for illiquidity.

Valuation Audit Process

General - The auditing procedures relating to the investment accounts of licensees require greater attention than those of a conventional commercial enterprise because of the relative significance of such assets to the licensee's financial condition.

Auditor's Responsibility - The independent auditor does not act as an appraiser for portfolio security valuations established in good faith by the Board or General Partner(s), is not expected to substitute his or her judgment for that of the licensee's Board or General Partner(s), and does not have the responsibility to determine or estimate the value of a licensee's portfolio securities.

The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith.

The independent auditor, however, does have the responsibility to examine, exercise appropriate due diligence and report on the reasonableness and adequacy of the methods, procedures, internal controls and documentation used by the licensee's Board or General Partner(s) in determining the fair value of portfolio securities.

Audit Procedure

1. **AICPA Audit Guide** - The audit procedures set forth in the AICPA's Guide for Audits of Investment Companies should be followed in auditing licensee valuations, supplemented by the following additional procedures.

2. **Conformity With Policy and Regulations** - The auditor should determine whether the valuation methods used conformed with the licensee's stated policy. The auditor should also determine whether the licensee's valuations met the minimum standards for valuation required by the regulations of the Small Business Administration.

3. **Valuation Methods** - The auditor should determine that relevant factors were considered in selecting the methods for valuation and that the methods used by the licensee to establish fair value were reasonable and prudent in the circumstances relating to the investment portfolio.

4. **Internal Procedures** - The auditor should determine that the internal procedures and controls used by the licensee to establish valuations were reasonable.

5. **Information Basis for Valuations** - The auditor should determine that the market factors, financial data and other information used to establish valuations was current, accurate and applicable to individual portfolio companies. Where appropriate, the auditor should test the information used as a basis for valuations. The extent of those tests should be based on the auditor's judgment and his or her study and evaluation of the data and procedures used to establish valuations.

6. **Documentation** - The auditor should determine that the valuations were adequetly documented and recorded.

Opinions on Valuation in the Independent Auditor's Report

Because most licensee portfolio securities do not have readily ascertainable market values, good faith valuations present a unique reporting situation for the independent auditor.

Consequently, the auditor has the option to issue an opinion in one of the following forms:

1. **Unqualified Opinion** - If the auditor concludes, based on examination of available evidence, that the process used to establish valuations is reasonable, the documentation is appropriate, and the range of possible values is not significant, he should issue an unqualified opinion on the valuations.

   The auditor may also choose to emphasize the inherent uncertainty about the valuations by inserting an informative paragraph in the audit report explaining the lack of definitive market values for the licensee's portfolio securities. An explanatory insert of this kind should not be considered a modification of, or qualification to, the auditor's unqualified opinion.

2. **Modified Opinion** - If the auditor concludes that the process used to establish valuations is reasonable and the documentation is appropriate, but the range of possible values of the licensee's portfolio securities is significant, the auditor's unqualified opinion should be modified to note the lack of ready market values and to indicate that the significant uncertainty about values could be material to a fair presentation of the value of the licensee's portfolio securities.

3. **Qualified Opinions**

   a. If the auditor's examination discloses that the valuation procedures do not conform with the licensee's policies or SBA's minimum standards for valuations, the auditor should issue a qualified opinion indicating a failure to comply with those policies or standards.

   b. If the auditor's examination discloses that the valuations are unreasonable or that the underlying documentation does not support the valuations, the auditor should issue a qualified opinion indicating a failure to conform with generally accepted accounting principles.

Notice to SBA - If a qualified opinion on valuations is issued, the auditor shall simutaneously notify SBA of the opinion, including with the notice a statement explaining the reasons for the qualified opinion and appropriate supporting documentation.

The **Chairman**. Thank you, Mr. Ewing.

Mr. Fletcher.

STATEMENT OF JAMES FLETCHER, VICE CHAIRMAN, NATIONAL ASSOCIATION OF INVESTMENT COMPANIES; CHAIRMAN, THE NEIGHBORHOOD FUND, INC.; PRESIDENT, SOUTH SHORE BANK, CHICAGO, IL, ACCOMPANIED BY JOANN H. PRICE, PRESIDENT, NATIONAL ASSOCIATION OF INVESTMENT COMPANIES, WASHINGTON, DC

Mr. **Fletcher**. Good morning, Senator.

The National Association of Investment Companies appreciates the opportunity to appear before the Senate Small Business Committee to discuss and address a variety of issues concerning the financial health and viability of the specialized small business investment company industry.

I am James Fletcher, vice chairman of the National Association of Investment Companies, and chairman of the Neighborhood Fund, a minority venture capital company owned by Shorebank Corp. I am also president of South Shore Bank of Chicago, and a member of the management committee of Shorebank Corp., which manages Shorebank Corp. and Southern Development Corp. in Arkansas.

I am pleased to have this opportunity to testify today and provide the minority venture capital industry perspective to your inquiry regarding the health of the industry. I have been in the venture capital business for close to 20 years. And in part of that I have seen the evolution and growth of the specialized investment company industry, and am proud of that 20 years that I have spent.

Also with me this morning is JoAnn Price, president of the National Association of Investment Companies.

I would like to take the opportunity right now to thank you, Senator, for the help and leadership that you provided last year in getting the legislation that has stabilized, for the first time, the funding to our industry. I would also like to point out that the radio company in the video that you saw was financed by three of the companies in the specialized SBIC industry.

And the importance of that is that that company is located in the inner city in the community and will provide jobs there, as opposed to a technology quarter outside the city.

As the Committee is aware, the Specialized Small Business Investment Company Program was created to provide patent capital to minority entrepreneurs across the country. It is with great pride that we have built an impressive track record in financing companies throughout the Nation to create value and provide jobs, and contribute to the economy of the country.

The pre-financing information on portfolio companies, which I have attached to my statement, demonstrates the increasing sophistication and success of our portfolio companies. The average returns in our portfolio companies have grown from $900,000 to well over a million in 1988. The average assets during the period from 1978 to 1988 have grown from $380,000 to well over $500,000 for the same period.

1990 marks the 20th anniversary of the specialized SBIC Program. The industry was created in 1970 as a black capitalist initiative. During this decade we have struggled to define the balance between social and economic roots in the industry. And the 1970's witnessed the failure of many of our companies unable to find the true balance between those two. At our 20-year mark in 1990, the industry is healthier than it has ever been.

Since 1970 we have invested over $1 billion in businesses owned by socially and economically disadvantaged entrepreneurs. We have traveled up the learning curve, and our members are now recognized as experts not only in the minority venture capital business, but in the venture capital business, period.

Just as important as our direct investments are the additional capital resources we bring to our deals. For every dollar we invest, we raise 2 additional dollars in bank and institutional financing to syndicate and structure deals. And, thanks to a large extent to the work of this Committee, after several years of funding shortages, we have stabilized funding that will allow us to continue to grow.

In 1990, we are still the primary institutional source of capital that dedicates 100 percent of its resources to minority financing. The philosophical justification for the creation of this industry was to stimulate and create a vehicle to be managed and operated by the private sector to invest in the sector of the economy that was not being served by traditional sources of financing. The rationale was sound and the results 20 years later provide documented evidence that the program does work.

In fact, our industry represents an increasingly vital source of capital to the minority business community. At the same time that we have increased our investments in minority business, other capital resources have dried up. Blacks in particular have experienced this as their portion of the SBA Guaranteed Loan Programs have gone from $97 million in 1970 to $180 million in 1980, all the way down to $71 million in 1988. We are one of the few remaining sources dedicated to minority business financing.

This Committee has expressed concern over the high risk nature of the program and has suggested that additional steps must be taken to minimize the risk the Government has. However, the legislative mandate to this industry operates and demands that we assume a high level of risk, that we participate in deals where capital cannot be raised through normal, traditional commercial sources, and that we increase the pool of minority firms across this country, which will certainly help this economy.

In fact, the Small Business Investment Act, as amended in 1972, provides for a special class of investment company whose investments, "Will be made in small business concerns which will contribute to the well balanced national economy by facilitating ownership in such concerns by persons whose participation in the free enterprise system is hampered because of social and economical disadvantage."

We have to create an economic environment where minority firms can grow, raise capital from diverse financial sources, and provide employment.

In 1979, the Small Business Investment Act was amended again as it relates to minority companies because it was felt that many of these investment companies were too conservative in their investment strategies, and that minority firms were not able to raise capital through the very investment companies that were created to serve their needs.

As a result, a special class of stock was created and to obtain eligibility for this next layer of Government leverage, minority investment companies were required to invest in equity securities defined as stock of any class or unsecured debt instruments which are subordinated by their terms to all other borrowings of the issuer. This means no collateral, not even personal guarantees. That is in the law.

Congress in its wisdom was willing to provide incentives to the private sector and challenge private industry to make an investment in a sector of the economy that was not being served by traditional finance. The private sector invested human capital and close to $250 million to operate successful investment companies. The total of Federal dollars invested in the specialized industry since its inception totals over $475 million.

With these funds and the profits we have generated, we have invested over $1 billion in minority deals. And for every dollar of capital we invest, 2 additional dollars are raised. The tax revenues collected in 1 year by local, State, and Federal Government total well over $141 million, as demonstrated by the chart attached to this testimony.

The amount of interest the industry has paid on its outstanding debentures to the Small Business Administration is estimated at approximately $75 million to date. Most importantly, the minority venture capital industry, in an aggregate, has been profitable since 1986.

Based on the data published by First Chicago Venture Capital Group, on a comparative basis, internal rates of return for private venture capital firms started after 1987 have been no greater than the yield of minority venture capital firms in this industry.

Our industry is now focusing on the potential gains we can realize as a result of the increase in our funding availability, increased interest by banks as a result of tighter compliance standards for the Community Reinvestment Act, and other factors that have produced a marked increase in the number of license applications that have occurred recently.

Although there have been many proven minority business success stories, the financial community has not substantially changed its financing criteria with respect to financing minority firms. The rhetorical question posed by several Senators on this Committee regarding the notion that the program may have outlived its usefulness is unfortunate.

The sad truth is that the larger venture capital community is not financing minority deals. The banking community is increasingly being subjected to more stringent credit tests by regulatory agencies, and are unwilling to take what they consider increased risk by financing small companies, even with SBA Guaranteed Loan Programs.

The need for a viable source of minority capital for minority enterprise is more critical today even than it was 20 years ago. The

National Association of Investment Companies represents all the firms that provide investment capital to minority firms.

There are only eight States that have developed capital programs directed at minority firms. They are Maryland, Massachusetts, Michigan, Florida, Minnesota, New York, Ohio, and Pennsylvania. There are seven additional private capital-type funds that do focus on minority investing. That is the total universe of capital that is available to minority business today other than the MESBIC industry.

In preparation for this hearing, the leadership of the National Association of Small Business Investment Companies as well as our officers discussed in detail the issues that have been the subject of a series of hearings held by this Committee over the last 2 months. We discussed issues relating to valuation, audits, regulatory compliance, licensing, as well as SBA's program management. Our legislative committee, as well as a task force of the board of directors, developed recommendations designed to improve the overall management of the program, and at the same time ensure to the extent possible that the Government role as a creditor is adequately protected.

We are pleased to present a document of recommendations agreed upon by both associations. And this document has been sent to the Administrator for her review and consideration.

Currently, those interested in operating specialized SBIC's must compile a comprehensive application that includes the statement of need, the investment philosophy, the management plan, and financial projections. In 1984, the qualifications for managers was strengthened to include very specific business investment skills. This was an improvement and an acknowledgement that talent is the single most important element in operating a successful small business investment company.

And with that in mind we would propose additional guidelines:

1. The management criteria should be more specifically described. The qualifications and responsibilities should be outlined in job descriptions.

2. Investors and stockholders should be required to receive an orientation about this program and understand the legislative history and the mandate of this program.

3. Management of the small investment company should be the core consideration during the review and evaluation process. The application should be revised to incorporate the management of the SBIC. Those interested in submitting an application should be told that this is one of the key considerations in the process.

We believe these changes would help to ensure the quality of new investment executives coming into the industry and strengthen the program in the long run.

Currently, all SBIC's undergo an audit performed by the Inspector General. It is looked upon as primarily a compliance audit that looks very specifically at the big six violations. Additionally, the company's CPA performs an annual financial audit. Beyond this information, the Investment Division asks investment companies to clarify, define, and correct certain practices as reported in an Inspector General examination.

Additionally, more effective monitoring of investment companies can be accomplished by instituting the following measures:

1. Incorporate in the annual SBA audit more specific information on valuation procedures. A written valuation policy and procedure should be required and reviewed as part of the audit process.

2. The policy and procedures providing guidance for valuation procedures should be rewritten, and more specific guidelines should be developed.

3. Investment company officials should visit investment companies annually to review management and investment strategies. These visits should be made after the annual financial audit and the 468's are submitted to the SBA. Written reports should be a part of the official file of the SBA.

4. The regulations, the standard operating procedures and the policy and procedural releases should be part of the official documents provided to companies when licensed by the SBA.

In addition to those recommendations regarding licensing and audit procedures, the association is working to include all of the operating policies and procedures of our industry.

In conclusion, Mr. Chairman and Members of the Committee, it has been our pleasure to appear before you this morning. We feel it is vital that this industry continue. You have been an ardent supporter of our industry and our program. We sincerely hope that when you conclude these oversight hearings the industry will be stronger for having been through this process.

The next 20 years are crucial to the continued development of the minority venture capital industry in this country. We have proven that we can be successful in investing in the specialized markets, and make a return on our investment. We have assisted in creating wealth and witness the positive impact that these companies have on their individual communities.

We have developed a venture capital talent, a national network, a deal flow, and institutional and entrepreneurial relationships. Our future need is the ability to convince institutional investors and pension funds that investing in minority business capital is an essential part of the minority economic development strategy, and is good for this country.

Thank you.

[The prepared statement of Mr. Fletcher follows:]

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Testimony by

James Fletcher

Vice Chairman, National Association of Investment Companies

Chairman, The Neighborhood Fund, Inc.

President, South Shore Bank
Chicago, Illinois

before the

Senate Small Business Committee

August 2, 1990

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The Neighborhood Fund, Inc.
Chicago, Illinois

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Dallas, Texas

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The National Association of Investment Companies appreciates this opportunity to appear before the Senate Small Business Committee to discuss and address a variety of issues concerning the financial health and viability of the Specialized Small Business Investment Company Industry.

I am James Fletcher, Vice Chairman of the National Association of Investment companies and Chairman of the Neighborhood Fund a minority venture capital company owned by Shorebank Corporation. I am also President of South Shore Bank in Chicago, Illinois. I am pleased to have the opportunity to testify today and provide the minority venture capital industry perspective to your inquiry regarding the health of the industry. I have been in the venture capital business for close to twenty years. I have been a part of the evolution and growth of the specialized investment company industry and am proud to be one of its twenty year veterans.

As the Committee is aware, the Specialized Small Business Investment Company program was created to provide patient capital to minority entrepreneurs across the Country. It is with great pride that we have built an impressive track record financing companies across the Country who have created value, provided jobs and contribute to the economy. The prefinancing information on portfolio companies which I have attached to my statement demonstrates the increasing sophistication and success of our portfolio companies. The average revenues of our companies has grown from $897,108 in 1978 to well over $1 million by 1988. The average assets have grown from $387,337 to $581,524 in the same time period.

1990 marks the twentieth anniversary of the Specialized SBIC program. The industry was created in 1970 as a "Black Capitalism" initiative. During our first decade, we struggled to define the balance between the social and the economic roots of the industry. The seventies were witness to the failures of many of our early companies which were unable to find that balance.

By 1980, much of the industry had moved up the learning curve and although we were not yet a profitable industry, we had every reason to be optimistic. The 80's promised to be our turning point. Although unprecedented interest rates and a recession delayed our progress -- not to mention a former president who tried for several years to eliminate the SBA and our program -- we did in fact become a profitable industry in 1986.

At our twenty year mark in 1990, the industry is healthier than it has ever been. Since 1970, we have invested over $1 billion in businesses owned by socially or economically disadvantaged entrepreneurs. We have travelled up the learning curve and our members are now the recognized experts in minority venture capital. Just as important as our direct investments is the additional capital sources we bring to our deals. For every dollar we invest, we raise an additional two dollars in bank or institutional financing to syndicate and structure deals. And, thanks to a large extent to the work of this Committee, after several years of funding shortages, we finally have access to the capital we need to continue to grow.

In 1990, we are still the primary source of capital that dedicates 100% of its resources to minority financing. The philosophical justification for the creation of the Specialized SBIC program (MESBICs) was to stimulate the creation of a vehicle managed and operated by the private sector to invest in a sector of the economy that was not being served by the traditional financial community. The rationale was sound and the results twenty years later provide documented evidence that the program works. In fact, our industry represents an increasingly vital source of capital to the minority business community. At the same time we have increased our investments in minority businesses, other capital sources have dried up. Blacks in particular have experienced this as their portion of SBA guaranteed loans has gone from $97 million in 1970 to $180 million in 1980 all the way down to $71 million in 1988. We are one of the few remaining sources dedicated to minority business financing.

Venture capital directed toward the minority community is probably one of the most creative tools to spur business growth and development. The mission is focused to perform very specific objectives. The goal is to invest in firms that have the ability to grow and provide a significant return to the investor.

The Committee has expressed concern over the high risk nature of the program and has suggested that additional steps must be taken to minimize the risk to the government. However, the legislative mandate that this industry operates under demands that we assume a high level of risk, that we participate in deals where capital cannot be raised through commercial sources, and that we increase the pool of minority firms across this Country. In fact, the Small Business Investment Act as amended in 1972 provides for a special class of investment company whose "*investments will be made in small business concerns which will contribute to a well balanced national economy by facilitating ownership in such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantage.*" We are to create an economic environment where minority firms can grow, raise capital from diverse financial sources and provide employment.

In 1979, the Small Business Investment Act was amended again as it relates to the minority investment companies because it was felt that many of the investment companies were too *conservative* in their investment strategies and that minority firms were not able to raise capital through the very investment companies that were created to serve their needs. As a result a special class of stock was created and to obtain eligibility for this layer of government leverage the minority investment companies were required to invest in equity securities defined as "*stock of any class or unsecured debt instruments which are subordinated by their terms to all other borrowings of the issuer.*" This means no collateral-- not even personal guarantees. This is the law.

Congress in its wisdom was willing to provide incentives to the private sector and challenged private industry to make an investment in a sector of the economy that is not being served by the traditional financial community. The private sector invested the human talent and close to $250 million to operate successful investment companies. The total federal dollars invested in the specialized investment company industry since the inception of the program totals $445 million. With these funds we have invested over $1 billion dollars in minority deals. And for every dollar of capital we invest two additional dollars are raised. The tax revenues collected in one year by the local, state and federal government total over $141,423,596 million, as demonstrated in the chart attached to my testimony. The amount of interest the industry has paid on its outstanding debentures to the Small Business Administration is estimated at approximately $75 million to date. Most importantly, the minority venture capital industry in the aggregate is a profitable industry since 1986.

Based on data published by First Chicago Venture Capital Group, on a comparative basis the internal rate of return for private venture capital firms started after 1987 has been no greater than the yield for the minority venture capital industry.

Perhaps because of the unique charter of the Specialized SBIC Industry, our recent experience regarding companies being transferred into liquidation has been different from that of the balance of the industry. Last year we lost only three companies. During the last ten years we have averaged only six companies transferred to liquidation each year. This represents a turnover rate of approximately 4.5%. This information is provided in a chart attached to my statement.

In testimony before the Senate Small Business Committee on March 22, 1988, NAIC President JoAnn Price indicated that a destabilizing environment was being created by the Reagan Administration over the proposals to eliminate the industry. We stressed that in a business that depended on stability these events would have a negative impact on the growth of the industry. We specifically pointed out that in 1980 when our funding was stable we had a private capital growth rate of 27%, but by 1987 our growth rate was less than 1%. We went on to say that for every company that entered the industry in 1987 and 1988, three left. When the Administration signalled a change in their position on the future of the agency private capital stabilized and continued to grow, and the number of companies exiting the industry began to shrink.

Our industry is now focusing on the potential gains we can realize as a result of the recent increase in our funding availability, increased interest from banks as a result of tighter compliance standards for the Community Reinvestment Act, and other factors which have produced a marked increase in the number of license applications.

Although there have been many proven minority business success stories the financial community has not substantially changed its financing criteria with respect to financing minority firms. The rhetorical question posed by several Senators on this Committee regarding the notion that the program may well have outlived its usefulness is unfortunate. The sad truth is that the larger

venture capital community is not financing minority deals. The banking community is increasingly being subjected to more stringent credit tests by regulatory agencies and are unwilling to take what they consider increased risks in financing small companies even with the SBA loan guarantee program. The need for a viable source of minority capital for minority entrepreneurs is more critical today then it was twenty years ago. NAIC represents all firms that provide investment capital to minority firms. There are only six states that have developed capital programs directed at minority firms. They are Maryland, Massachusetts, Michigan, Florida, Minnesota, New York, Ohio, and Pennsylvania. There are seven additional private venture capital type funds that do focused minority investing. That is the total universe of capital that is available to the minority business community today other than the MESBIC industry.

In preparation for this hearing, the leadership of the National Association of Small Business Investment Companies (NASBIC) as well as our officers discussed in detail the issues that have been the subject of the series of hearings held by this Committee over the last two months. We discussed issues related to valuation, to audits, to regulatory compliance, to licensing, as well as SBA's program management. Our Legislative Committee as well as a task force of the Board of Directors developed recommendations designed to improve the overall management of the program and at the same time ensure to the extent possible that the government role as a creditor is adequately protected. We are pleased to present a document of recommendations agreed to by both associations to the Committee. This document has been sent to Administrator Engeleiter for her review and consideration.

Through most of these hearings, we have heard repeated testimony regarding the government exposure and the concern over potential losses of government funds. We are confident that this industry-developed document, which is already followed by many investment companies, will ensure our company executives are utilizing a prudent approach in valuing their investment portfolios. We also have specific recommendations to make regarding the questions you posed to us in your letter of invitation.

Views of Present Licensing and Auditing System

Our industry's years of experience have taught us many things, chief among which is the fact that the most important determinant of an investment company's success is the talent of the investment executive. We believe the licensing process should be modified to place more emphasis on this factor.

Currently, those interested in operating Specialized SBICs must compile a comprehensive application that includes the statement of need, the investment philosophy, the management plan and the financial projections. In 1984, the qualifications for managers were strengthened to include very specific business investment skills. This was an improvement and an acknowledgement that talent is the single most important element in operating a successful small business investment company. We would propose additional guidelines:

1. The management criteria should be more specifically described. The qualifications and responsibilities should be outlined in a job description.
2. Investors and stockholders should be required to receive an orientation about the program and understand the legislative history and mandate.
3. Management of the small business investment company should be the core consideration during the review and evaluation process. The application should be revised to incorporate the management of the SBIC. Those interested in submitting applications should be told that this is one of the key considerations during the review process.

We believe these changes would help to ensure the quality of new investment executives coming into the industry and strengthen the program in the long run.

Currently all SBICs undergo an audit performed by the Inspector General. It is looked upon as primarily a compliance audit that looks very specifically at the big seven violations. Additionally, the company's CPA performs an annual financial audit. Beyond this information, the Investment Division asks investment companies to clarify, defend or correct certain practices as reported in the IG examination.

Unfortunately, the audits vary from one region to the next. While auditors in one region may be thorough in their examination of company financials and practices, requiring investment companies to provide detailed information on their valuations of portfolio companies, auditors in other regions may be comparatively lax in the same areas. We believe it is important for audits to be standardized from one region to the next. If auditors do not currently have standard operating procedures and professional standards, they should be adopted to help in this regard.

Additionally, more effective monitoring of investment companies can be accomplished by instituting the following measures:

1. Incorporate in the annual SBA audit more specific information on valuation procedures. A written valuation policy and procedure should be required and reviewed as part of the audit process.

2. The policy and procedure providing guidance on valuation procedures should be rewritten and more specific guidelines should be developed.
3. Investment company officials should visit investment companies annually to review management and investment strategies. These visits should be made after the annual financial audit and the 468 are submitted to the SBA. Written reports should be a part of the official file.
4. The regulations, the standard operating procedures and the policy and procedural releases should be part of the official documents provided to companies when licensed by the SBA.

How Auditing Procedures Might be Improved to Provide More Reliable and Complete Information

NAIC shares this Committee's goal of maintaining the strength and integrity of the SBIC industry. As this Committee has worked to identify the source and extent of problems within the industry, as I indicated earlier, our leadership has worked with the NASBIC leadership to develop measures which would minimize their potential recurrence.

As a result of this process we have developed a set of minimum standards for portfolio company valuations. These standards would require companies to be more conservative in their valuations, writing investments up or down only when market conditions dictate those changes.

We also have specified guidelines regarding an investment company's documentation of its valuation policy and procedures. These policies, procedures and documents would be subject to review by the company's independent auditor, who would issue an opinion on the reasonableness of the policies and procedures and the appropriateness and adequacy of the documentation.

We believe that these proposals will help to significantly improve the monitoring and valuation policies of companies, leading to their early detection of potential problems with portfolio companies. With early detection, our investment company executives will be able to work with their entrepreneurs to minimize potential losses to both the portfolio company and the investor.

Recommendations on How to Improve the Program

In addition to our recommendations regarding licensing and auditing procedures, NAIC is working to improve all the operational policies and procedures of our industry.

Our Education Committee is currently working on an Investment Operations Manual which will provide companies with detailed procedures and documents in a full spectrum of areas. We are collecting operational documents, checklists, and other forms used by investment executives from across the country to help identify those which have proven most useful and effective. These will be shared with the entire membership so that all our companies will have the benefit of the best information available.

This manual will be completed by late October, at which time we will distribute it to the industry.

Conclusion

Mr. Chairman and members of the Committee, it has been our pleasure to appear before you this morning. We feel it is vital that this industry continue. You have been an ardent supporter of our industry and our program. We sincerely hope that when you conclude these oversight hearings, the industry will be stronger for having been through this process. The next twenty years are crucial to the continued development of the minority venture capital industry. We have proven that we can successfully invest in specialized markets and make a return on investment. We have assisted in creating wealth and witnessed the positive impact many of these companies have had on individual communities. We have developed the venture capital talent, the national network, the deal flow and the institutional and entrepreneurial relationships. The future need is the ability to convince institutional investors and pension funds that investing in minority venture capital is an essential part of the minority economic development strategy.

PREFINANCING INFORMATION ON MESBIC-FINANCED BUSINESSES

REVENUE

YEAR	AVERAGE	MEDIAN	TOTAL
1988	$1,114,058	$383,474	$411,000,000
1987	$861,136	$341,049	$371,000,000
1986	$959,809	$330,223	$366,000,000
1985	$884,634	$327,247	$351,000,000
1984	$813,550	$220,652	$290,000,000
1983	$937,901	$300,675	$234,000,000
1982	$650,800	$195,689	$163,000,000
1981	$797,693	$210,795	$186,000,000
1980	$818,357	$254,032	$143,000,000
1979	$897,651	$265,000	$134,000,000
1978	$897,108	$305,556	$120,000,000

ASSETS

YEAR	AVERAGE	MEDIAN	TOTAL
1988	$581,524	$220,560	$238,400,000
1987	$562,004	$234,444	$255,000,000
1986	$641,440	$207,462	$260,000,000
1985	$572,960	$211,270	$242,000,000
1984	$530,449	$201,190	$215,000,000
1983	$595,053	$201,923	$165,000,000
1982	$499,904	$186,688	$131,000,000
1981	$423,689	$190,929	$113,000,000
1980	$609,936	$182,500	$119,000,000
1979	$517,230	$170,833	$77,000,000
1978	$387,337	$144,022	$59,000,000

1989 SPECIALIZED SBIC INVESTMENT STATISTICS

SBA Leverage	SSBIC Investments	Est. Total Financing	
$28 million	$148 million	$444 million	
		$148 M SSBICs	$296 M other private $

Total Number of Companies Financed	1,254
Estimated Revenues of SSBIC Portfolio Companies	$1,380,513,500
Estimated Total Employees	16,302
Estimated Portfolio Company Employees Payroll:	
Federal Taxes	$48,906,000
State and Local Taxes	$16,954,080
	$65,860,080
Estimated Portfolio Company Taxes Paid:	
Federal	$12,424,621
State/Local	$6,212,311
	$18,636,932
Estimated Payroll Taxes Collected	
FICA: Employees	$24,485,604
Company	$24,485,604
Total	$48,971,208
Unemployment Taxes:	
Federal	$912,912
State	$7,042,464
Total	$7,955,376
Total Governmental Collections	$141,423,596

Specialized SBICs Transferred Into Office of Portfolio Management
1972 - 1990

Year	Amount Due SBA From Cos. Transferred	Number of Cos. Transferred	Number of Cos. In Industry	Turnover Rate
1972	$600,000	1		
1974	$300,000	1		
1976	$600,000	2		
1977	$1,000,000	1		
1978	$4,000,000	6		
1979	$9,861,957	8	110	7.27%
1980	$4,636,700	8	121	6.61%
1981	$5,571,950	8	130	6.15%
1982	$8,230,000	5	127	3.94%
1983	$2,850,000	3	144	2.08%
1984	$16,020,000	6	146	4.11%
1985	$5,220,000	3	148	2.03%
1986	$17,232,986	11	137	8.03%
1987	$16,249,500	10	135	7.41%
1988	$8,698,615	5	127	3.94%
1989	$6,330,000	3	132	2.27%
1990	$4,660,000	2	134	1.49%
	$112,061,708	83		

GUIDELINES FOR THE VALUATION OF PORTFOLIO SECURITIES

Objective - These guidelines are intended to provide (1) a conservative basis for establishing the fair value of portfolio securities held by licensees, (2) a set of consistent valuation standards which can be relied upon by the licensee's investors and the government, and (3) a uniform audit process to verify the reasonableness of the licensee's valuations.

Responsibility - The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith. It is incumbent upon the Board of Directors or General Partner(s) to satisfy themselves that all appropriate factors relevant to fair value have been considered and the method used to establish fair value is reasonable and prudent.

Methodology - No single method for determining value in good faith can be established, since fair value depends upon the circumstances of each individual financing and investments by licensees are generally venture-type investments in closely held, non-mature small firms whose stock is not publicly traded. Acceptable valuation methods may be based, for example, on the financial condition and/or earnings capacity of the small concern, a multiple of earnings, a discount from or a premium higher than the market price of a similar security that is freely traded, a yield to maturity for debt securities, or on a combination of those or other factors. All relevant factors should be considered in selecting the method of establishing the fair value of each portfolio security.

Procedure - The Board or General Partner(s) may appoint management or other individuals to assist in the valuation process, to provide supporting data and to make necessary calculations.

Documentation

(1) Each licensee shall develop and maintain a written statement, approved by the Board or General Partner(s), of its valuation policy and procedures.

(2) Each valuation decision should be set forth in the minutes of the Board/Partner(s) meeting.

(3) Each licensee shall prepare and retain in its files a valuation report for the valuation of each portfolio security which documents the factors, methodology, supporting data and calculations used to establish value.

(4) Licensees shall obtain current financial statements from each portfolio concern at least annually, except as noted below. Such financial statements may be unaudited, but shall include a statement of assets and liabilities and a profit and loss statement. Where production of financial statements would cause undue hardship to the small concern or financial statements are not essential to valuation of the portfolio security, the Licensee shall obtain a copy of the small concern's most recent Federal income tax return.

Frequency - Portfolio securities should be valued at least annually as of the close of the licensee's fiscal year, or more frequently where deemed necessary by the Board or General Partner(s).

Minimum Standards for Valuations - Each licensee should apply the following minimum standards to the valuation of its portfolio securities, and all valuation adjustments should be disclosed in the licensee's valuation report for the affected portfolio concern:

Securities of Private Companies

1. Investment cost is presumed to represent value except as indicated otherwise in these standards.

2. Valuation should be reduced if the portfolio company's performance and potential have significantly deteriorated.

3. Valuation should be adjusted to equate to a subsequent significant equity financing that includes a sophisticated, unrelated new investor. A subsequent significant equity financing that includes substantially the same group of investors as the prior financing should generally not be the basis for an adjustment in valuation.

4. Valuation may be adjusted if the company has been self financing for at least two years and has been cash flow positive for at least one year. The adjustment should be based on P/E ratios, cash flow multiples or other appropriate financial measures of similar companies. The valuation should be discounted by an appropriate percentage for illiquidity, unless liquidity is provided for through redemption or registration rights.

5. Warrants and options should be valued at the excess of the value of the underlying security over the exercise price.

6. Valuation of convertible debt should be adjusted to reflect the value of the underlying security net of the conversion price.

7. Valuation of collateralized securities should include consideration of the value of the underlying collateral, and appropriate adjustments should be made for changes in the value of that collateral.

8. The carrying value of interest bearing securities should not be adjusted for changes in interest rates.

9. Valuation of interest receivables on interest bearing securities should reflect the portfolio concern's financial condition, its payment history and its ability to generate sufficient cash flow to make interest payments. Past due interest should not be valued or converted to a security with carrying value if: (a) interest payments are in default more than six (6) months; (b) the ability of the company to make payments is considered doubtful; and (c) the interest bearing securities do not have a substantial underlying equity value as determined by the above criteria.

Securities of Public Companies

1. Publicly traded securities should be valued at the closing price or bid price except as indicated otherwise in these standards.

2. The valuation of public company securities that are restricted should be discounted appropriately until the securities may be freely traded.

3. When the number of shares of publicly traded securities held by the licensee is substantial in relation to the usual quarterly trading volume, the valuation should be discounted by an appropriate percentage for illiquidity.

Valuation Audit Process

General - The auditing procedures relating to the investment accounts of licensees require greater attention than those of a conventional commercial enterprise because of the relative significance of such assets to the licensee's financial condition.

Auditor's Responsibility - The independent auditor does not act as an appraiser for portfolio security valuations established in good faith by the Board or General Partner(s), is not expected to substitute his or her judgment for that of the licensee's Board or General Partner(s), and does not have the responsibility to determine or estimate the value of a licensee's portfolio securities.

The licensee's Board of Directors or General Partner(s) has (have) the sole responsibility for valuing portfolio securities in good faith.

The independent auditor, however, does have the responsibility to examine, exercise appropriate due diligence and report on the reasonableness and adequacy of the methods, procedures, internal controls and documentation used by the licensee's Board or General Partner(s) in determining the fair value of portfolio securities.

Audit Procedure

1. **AICPA Audit Guide** - The audit procedures set forth in the AICPA's Guide for Audits of Investment Companies should be followed in auditing licensee valuations, supplemented by the following additional procedures.

2. **Conformity With Policy and Regulations** - The auditor should determine whether the valuation methods used conformed with the licensee's stated policy. The auditor should also determine whether the licensee's valuations met the minimum standards for valuation required by the regulations of the Small Business Administration.

3. **Valuation Methods** - The auditor should determine that relevant factors were considered in selecting the methods for valuation and that the methods used by the licensee to establish fair value were reasonable and prudent in the circumstances relating to the investment portfolio.

4. **Internal Procedures** - The auditor should determine that the internal procedures and controls used by the licensee to establish valuations were reasonable.

5. **Information Basis for Valuations** - The auditor should determine that the market factors, financial data and other information used to establish valuations was current, accurate and applicable to individual portfolio companies. Where appropriate, the auditor should test the information used as a basis for valuations. The extent of those tests should be based on the auditor's judgment and his or her study and evaluation of the data and procedures used to establish valuations.

6. **Documentation** - The auditor should determine that the valuations were adequetly documented and recorded.

Opinions on Valuation in the Independent Auditor's Report

Because most licensee portfolio securities do not have readily ascertainable market values, good faith valuations present a unique reporting situation for the independent auditor.

Consequently, the auditor has the option to issue an opinion in one of the following forms:

1. **Unqualified Opinion** - If the auditor concludes, based on examination of available evidence, that the process used to establish valuations is reasonable, the documentation is appropriate, and the range of possible values is not significant, he should issue an unqualified opinion on the valuations.

   The auditor may also choose to emphasize the inherent uncertainty about the valuations by inserting an informative paragraph in the audit report explaining the lack of definitive market values for the licensee's portfolio securities. An explanatory insert of this kind should not be considered a modification of, or qualification to, the auditor's unqualified opinion.

2. **Modified Opinion** - If the auditor concludes that the process used to establish valuations is reasonable and the documentation is appropriate, but the range of possible values of the licensee's portfolio securities is significant, the auditor's unqualified opinion should be modified to note the lack of ready market values and to indicate that the significant uncertainty about values could be material to a fair presentation of the value of the licensee's portfolio securities.

3. Qualified Opinions

   a. If the auditor's examination discloses that the valuation procedures do not conform with the licensee's policies or SBA's minimum standards for valuations, the auditor should issue a qualified opinion indicating a failure to comply with those policies or standards.

   b. If the auditor's examination discloses that the valuations are unreasonable or that the underlying documentation does not support the valuations, the auditor should issue a qualified opinion indicating a failure to conform with generally accepted accounting principles.

Notice to SBA - If a qualified opinion on valuations is issued, the auditor shall simutaneously notify SBA of the opinion, including with the notice a statement explaining the reasons for the qualified opinion and appropriate supporting documentation.

The CHAIRMAN. Thank you, Mr. Fletcher.

Mr. Ewing, let me start off by saying that you are faced with something like we are sometimes faced with in the Senate. You have one or two Senators before the Ethics Committee, and the American people conclude that everybody in the Senate is guilty of whatever that person is charged with. We do not like it. And we do not think the press treats it fairly, and so on.

But I have learned from 20 years in this business, if you cannot handle that you are in big trouble in this business. It is new to you and it is new to your association. And it is regrettable that these hearings had to be held. But to not hold them would be the height of irresponsibility. And for some people to conclude in their comments, either editorially or in news accounts, that somehow everybody in the program was bad and rotten and defrauding the Government, there is not anything any of us can do about that. That is just the nature of the business, and so it is regrettable.

But I personally think, regardless of what happens to SBIC—I rather expect the program will continue, we will know a little bit more about that after we hold the next hearing and get the Inspector General's report. I have always been a great champion of SBIC's, and one of the things, as I said in my opening statement, that Senator Weicker and I probably relied on more than anything else was the success of some of the companies the SBIC had invested in as a rationale for not shutting SBA down.

Having said all of that, if I were going to hone in on one thing that I think is more important as a result of these hearings than anything else, it is how these SBIC's are to be audited and how the valuations of their portfolios is to be determined. I have not had an opportunity to look over in detail the guidelines that your association is suggesting, and we welcome that, incidentally. I think that is a very legitimate and good move on your association's part.

But you heard the testimony of Ms. Engeleiter this morning. And in my opinion, unless we can get more help for the Investment Division over there, and maybe even the Inspector General, we are likely to continue to have some of these. I want to resolve this problem once and for all. I want us to come up with guidelines that you and I are both comfortable with, that you do not feel is an unnecessary intrusion on your business judgment, and that you do not feel effectively amount to a micromanagement of the SBIC's and the special investment companies.

Now that is a pretty tall order, because all of these things are like beauty being in the eye of the beholder. For example, one of the things that you talk about in one of your suggestions is qualified opinions, which I assume would be the highest rating an SBIC could get under your proposal. If the auditor concludes, based on the examination of available evidence, that the process used to establish valuations is reasonable, the documentation is appropriate, and the range of possible values is not significant, he should issue an unqualified opinion.

How would one determine whether or not the range of possible values is significant? If I look in your portfolio, as I understood in your testimony, your company has invested and now holds stock or loans in 29 companies. Is that correct?

Mr. EWING. Currently, 19. But over our history we have had 29.

The CHAIRMAN. So you are currently invested in 19?

Mr. EWING. Yes, sir.

The CHAIRMAN. Just to go back a moment, tell me who does your audits?

Mr. EWING. Peat Marwick.

The CHAIRMAN. When Peat Marwick comes into your plant and they go right to the heart of the reason for their being there, and that is the valuation of your portfolios, tell me what you tell Peat Marwick. What do they ask and what do you tell them about the way you have established these values? And I assume largely on stocks that are not traded on the market.

Mr. EWING. Yes, sir. Actually, I think the first step is to establish a set of valuation guidelines. And whether SBIC's have them formalized or have them just orally, every SBIC has got a set of valuation guidelines which is a part of our evaluation process. Basically the proposal that we are making is that we standardize that valuation guideline. For each company, we would review with Peat Marwick the status of that company. We would look at financial information on that company. And we would propose the value—actually, we and our advisory committee determine a value for those companies. And then Peat Marwick comes in and tries to test our logic on that valuation and, basically, methodology.

The difficulty here, Mr. Chairman, is that it is virtually impossible for an independent CPA firm to, in any finite way, determine what the value is of a portfolio company, particularly when a lot of the companies invested in by the industry are companies in various stages of development, which do not lend themselves to the analytical and valuation formula that you might have for listed companies. You suggested that most of our companies are probably not on any market, and that is true. Of the 19 companies we have, 18 are not marketable in any way. And we have one company that is on the over-the-counter market. And that one is easy to value.

But the other 18 companies generally require a significant review by us. Of course, in our case, we are monitoring these companies on a monthly and more often basis.

The CHAIRMAN. Do they submit financial statements to you on a monthly basis?

Mr. EWING. In most cases we require monthly financial statements. There are some SBIC's that invest with a different philosophy than we have that do not require financial statements that often. And there are some companies in our portfolio that provide financial statements on a quarterly basis. Certainly, every company would provide financial statements of some sort on an annual basis. And those statements could be available for review. And in fact, in our case, are available for review with Peat Marwick. And Peat Marwick tests us on our valuations and says, gee, we think we need to do some more work on this one. And that process goes on today.

But I submit that there is no way in our case that Peat Marwick can determine what the value is. They can test our logic, but they cannot determine what the value is. Even if they went out to the company site and did a review there, it would be virtually impossible, in my opinion, for them to determine what the value of the company is.

So what we have proposed in our valuation guidelines is that we establish an industry-wide method of determining valuations. And in those guidelines, we have tried to think of all of the situations that companies might find themselves in. As you know, some SBIC's are lenders only. And they have a different method of valuation, or a different valuation requirement if you will, than people in my segment of the business, which basically invest in equities of growth capital companies.

And you can imagine the valuation techniques would be dramatically different. But we have tried to address those in the valuation guidelines.

The CHAIRMAN. Do you do lending also?

Mr. EWING. It depends on the case. The answer is yes, but only as a smaller portion of our portfolio. But you ask a good question, Mr. Chairman, because if SBIC's do not have some form of interest income or dividend income from their portfolio, then they cannot generate the cash that is necessary to pay interest on the SBA debt.

In our case we try to match the amount of income that we have from our portfolio, through dividends and interest, with the amount of interest that we are obligated to pay onto SBA debt. And well managed SBIC's manage that well.

The CHAIRMAN. I take it that oftentimes there is a consortium of SBIC lending or purchase of equities. In the case of Fred Smith, for example, at Federal Express, I assume that several—because I know Fred well. I was Governor of the State when he started out in Little Rock.

To show you how smart I am, my brother, who was president of Greyhound Financial at the time, called me and said do you know a guy named Fred Smith. And I said yes. And he said what do you know about him. And I said well, he has got this crazy notion that he can send letters all over the United States at night. I said I think he is about under now. There is no way in the world he can make it. [Laughter.]

And so my brother turned him down for financing. He also claims the honor of turning Ray Kroc down on his McDonald's franchise because all he had was a bunch of knives and forks. But in that case, as I say, I know Fred and I know what his needs were when he was trying to buy those airplanes, for example. And ultimately PanAm financed those for him.

I assume that no one SBIC could come close to handling what he needed at that time. And I assume that whatever he borrowed was from several different ones. I mean each one of you putting in a half a million or something like that.

Mr. EWING. Yes, sir, exactly. I do not know the specifics of that case, but if my memory is correct, there were about nine rounds of financing in the Federal Express case. And it was not clear until the latter ones of those that the company really was going to make it.

And the example of the radio station on the film clip had three specialized investment companies investing in that. And I think that it is typical of the SBIC industry in general. There are generally more than one SBIC investing in the company. I mentioned a company in Baltimore that we are an investor in. There are four SBIC's that support that company.

There is another one I mentioned in Sterling, VA, which has two other SBIC's besides us that support that company.

And frankly, we are interested in sharing the risk. The beauty of the SBIC Program is that you have got the private capital beneath the Government, and the managers, whether it is their own private capital, or in my case, the capital of a bank that I manage capital for, are very concerned about preserving and making that private capital grow. So when we look at an investment we are trying to figure out how to make money. But at the same time we do not want to lose money.

And almost always companies require more capital than they initially project. And so it is helpful to have several companies if the company needs to pass the hat for another round of financing.

The CHAIRMAN. If you require $2 million up front, you are going to eliminate a lot of interest in the program, are you not?

Mr. EWING. I expect you would, yes, sir. But I think the practical considerations are that in order to have a professional manager and also not pay a disproportionate amount of compensation benefits as a percentage of the total capitalization of the business—let us say that in order to put together an SBIC you had to have $150,000 of management and facilities and travel and legal and office supplies and telephone, and all the things that would be involved in running an office. If you have a $1-million SBIC, that is a very large percentage. But if you have a $2-million or $3-million SBIC, it is a much smaller percentage.

In the case of some SBIC's, they are sister companies or affiliated with other SBIC's, and perhaps there is reason to allow a smaller size for those, because they have other ways to cover their management overhead. But in very small SBICs, you use up a fair amount of the capital or interest income earned on that capital just paying the operating expenses. And you, in effect, may eat away at the capital at those small levels.

Additionally, persons that might be attracted to manage those small SBICs and the limited compensation they might be able to afford are perhaps less qualified than others that might be attracted.

The CHAIRMAN. How old is your company, Mr. Ewing?

Mr. EWING. Crestar Capital, the SBIC was licensed 6 years ago in November.

The CHAIRMAN. Are you profitable?

Mr. EWING. Yes, sir, we are profitable. Well, let me put it this way. We were profitable last year. We expect to be profitable this year. We were not profitable during the first few years of our operation. And I think that is fairly consistent among any venture capital operation. Your losses tend to show up before your gains do.

The CHAIRMAN. Mr. Ewing, let me say that if I can get my seed capital or my venture capital bill, either one, passed, it will certainly be a big boon to your industry. I feel very strongly about it. I do not have any Administration support for it, but I do not support the President's capital gains proposal. I do support mine, which principally benefits your industry.

Mr. EWING. Yes, sir.

The CHAIRMAN. And right now, with the economy in a difficult position, small business is going to have a very tough time coming up with capital to do anything.

Mr. EWING. And I think that is one of the points that I would like to reemphasize. In this environment, with banks basically not lending to much of anyone, particularly small business, this is the time when capital is not only necessary for small businesses, but also can be invested in such a manner to produce attractive returns, and therefore benefit the SBICs in the long run.

What I am trying to say in a long-winded fashion is that prices are down. And as a result, companies cannot find financing from banks. They cannot find financing from other sources. And pricing for SBIC's investments is better. Now the effect of that will not be seen for several years. But we are beginning a cycle, or we are just into a cycle where SBIC financing is absolutely essential, and probably makes more economic sense than it has for the last up cycle.

The time to invest is when things are—you know, buy low, sell high. That is the concept I am trying to emphasize. This is the buy low time. So if we scrap the program in the time when we have an opportunity to buy low, I think we are doing it at the wrong end of the cycle.

The CHAIRMAN. I appreciate your testimony. I think if I were going to take exception to anything in your testimony, I think you are minimizing the losses we are facing right now with some of the SBICs. And again, I would say it is unfortunate that we have people like River Capital which bring this sort of thing out. And we are forced, in light of that, to do our duty. And that is to figure out how many River Capitals are there out there.

Mr. EWING. Can I make one comment in response to that, sir?

The CHAIRMAN. Certainly.

Mr. EWING. I tried to make a reference to the fact that Apple Computer's tax payments by themselves for 1 year were enough to cover the industry's losses for its history. And that is really a superficial and inadequate analysis. But the unfortunate thing is that we do not have a mechanism to evaluate the benefits of this industry. We can see that we may have lost $250 million, or maybe the number is higher than that. But we do not have a mechanism to say how we have benefited, how many jobs have we created, how many new taxes have been created, what kind of innovation has been created.

So, in just a simple fashion, if SBIC's could take all the credit for Apple Computer, which they certainly cannot do, but if they could, just that one company's tax payments for 1 year would support the industry's losses. And if we could do an analysis like that, and I am not sure the data is available to do it, but if we could do an analysis like that, I think we would find that the benefits of the industry far exceed a reasonable amount of losses.

Now we do not know what those losses are, and we certainly do not want the losses to be any larger than you want them to be. So we would certainly like to cooperate with you in finding ways to minimize these losses.

The CHAIRMAN. All the Federal Expresses and Cray Researches in the world would not relieve this committee, though, of its responsibility to ferret out fraud and try to tighten the program to minimize losses. And in the final analysis, that will rebound to your benefit and the other healthy SBICs benefit.

Mr. **Ewing**. Yes, sir.

The **Chairman**. Let me ask one final question. How would you feel about the Government, in putting their stake in your company, taking an equity position in your company?

Mr. **Ewing**. Well, I would like to think about that, Mr. Chairman. [Laughter.]

That is a loaded question.

The **Chairman**. Well, it is not intended to be. It is intended to be an honest question.

Mr. **Ewing**. I think it would change the interest that investors have in SBICs.

The **Chairman**. You would not want Ms. Engeleiter sitting on your board?

Mr. **Ewing**. Well, I do not know that I would. Effectively, with the regulation that we have, while Ms. Engeleiter does not sit on the board, she gets a lot of information and knows well what is going on in our organization.

I think the concern that I would have is the beauty of the SBIC Program is it allows people to enter the business of supporting and investing in small businesses by giving the SBA guarantee. And people would not take advantage of that program if they had an option. I guess that is what I am trying to say. You would go without Government oversight if you had an option.

The reason that people choose to enter the program is because it lets them take $1 million in capital, or $2 million in capital, and make a larger fund to invest. And in return for that, we invest in small businesses. And that is the quid pro quo.

If the Government comes in and wants to be a partner in the business, I think it just changes the whole spectrum of your decision process as to whether you invest in an SBIC or whether you do something else. And I do not know of any experiences in State and local government, and there probably are some, but I am not aware of any, where a combination of public/private fund has been successful in a venture capital operation.

Mr. **McNeish**. Except for the one sitting next to you.

Mr. **Ewing**. Well, I am not aware of Mr. Fletcher's business. So there are some that are successful. But, generally, it is very difficult for the public/private partnership in the management side to be successful, at least in my view.

The **Chairman**. One final question, and I said that was the final one, but one other. Your suggestion that SBICs put up $2 million initial capital, would you then require $6 additional million from the SBIC? Would you leave the ratio the same, 4 to 1?

Mr. **Ewing**. Actually, with the revision that we suggested about the fourth tier, it would be between 3 and 4 to 1, with the fourth tier being structured a little bit differently. But we would propose that there would still be three tiers, and potentially a fourth tier.

The **Chairman**. Are you just saying require the SBIC to put up more up-front capital?

Mr. **Ewing**. That is right, just to have a bigger mass, the critical mass that allows you to operate.

The **Chairman**. Thank you very much, all of you, Mr. Fletcher and Mr. Ewing, for being with us this morning.

We will stand adjourned until the call of the Chair.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

APPENDIX

NASBIC

June 4, 1990

Editor of Business Week
c/o Readers Report
Business Week
1221 Avenue of the Americas
New York, NY 10020

Dear Sir:

Our industry has been a strong supporter of your coverage of small business issues. Unfortunately, your article on Small Business Investment Companies ("The Iran-Contra Scandal of the Small Business World," Small Business, June 4) is irresponsible journalism that has unfairly damaged a sound financial program important to small business.

Your article paints the SBIC industry as a good program that has gone bad, has outlived its usefulness, is mired in defaults and may be closed down by Congress. That portrayal is totally unfounded, based on factual errors, half-truths, misleading innuendo and wrong conclusions.

The SBIC program continues to have a positive record of building small companies. Congress is quite aware of the outstanding results achieved by the SBIC industry, and has no intention of terminating the program.

The assertion in the article that the "market is sending signals that the program may have outlived its usefulness" is completely at odds with reality. In today's credit crunch climate, banks and other conventional sources of capital have become risk-averse to small business, making venture financing by SBICs for small growth companies more essential than ever.

The truth is that SBICs have provided over $9.0 billion in critically needed venture capital to over 60,000 small growth companies. Certainly, we're proud of our outstanding successes - home runs like Federal Express and Apple Computer. But even more important, we continue to provide capital to a broad array of less spectacular - but equally essential - small businesses that fuel the American economy. These are the singles, doubles and triples by successful, growing companies that produce jobs, innovations and new products and pay taxes.

President
PETER F. McNEISH

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The implication in your article that SBICs are similar to "hemorrhaging thrifts" that were thinly capitalized and poorly managed is a gross distortion. Every SBIC has a private capital base equal to at least 25% of its assets, and in most cases far higher. Currently, the 401 SBICs in the program have private capital of $1.9 billion, which far exceeds the $1.2 billion of government-backed loans outstanding.

It is true that the rate of SBIC defaults has increased over the past five years. That fact should not be surprising for a high-risk investment business in the context of an economy that has seen many segments of the financial markets experiencing difficulties. However, even here the picture your article paints is distorted. According to official SBA statistics, 160 SBICs are currently in default with loans of $486 million (not the $563 million figure cited in your article). More important, that is a cumulative figure aggregated over an extended period of years - dating back to the 1960s. Over that same period 1,500 SBICs have been licensed and $3.0 billion has been loaned to them. Therefore, only 11% of all SBICs and 16% of all funds loaned to SBICs are currently in default - percentages we find quite defensible for a high-risk venture investment program.

Your article incorrectly suggests that a default means the SBIC has been a total failure and the government stands to lose all funds loaned to that company. In fact, many SBICs, prior to going into liquidation, have made a substantial number of successful investments, and many of those assets have substantial value. Moreover, the major losers when an SBIC defaults are the private investors who lose all their invested capital before Uncle Sam loses one dime. Because private dollars buffer the government from losses, and the SBA has been able to realize value from the assets of defaulted SBICs, the government's actual rate of recovery on SBIC defaults has been 68.7% and its net realized loss from the SBIC program has been less than 2%.

Your article incorrectly implies that the government will have to come up with hundreds of millions of dollars to pay for losses on SBIC defaults, similar to the S&L bailout. In fact, the program was designed to anticipate losses because of its high-risk nature. SBA has provided an annual reserve for losses for the past 32 years. The reserve fund is more than sufficient to cover all projected losses from the program, and additional taxpayer dollars to cover losses will not be required.

The article incorrectly asserts that large hidden losses in the program will soon emerge, claiming that 20% of the operating SBICs are "candidates for failure." In fact, SBA's rating of operating SBICs has determined that only 4% of currently operating SBICs are in an unsatisfactory status. The article also lifts a quote from a consultant's report out of its proper context to suggest that the default trend was moving from a "critical to melt down stage." In fact, that quote did not refer to default trends. Rather, it characterized SBA's understaffing and insufficient resources to manage assets in liquidation.

Your article incorrectly states that budget cuts forced the SBA to cut back its annual audits of SBICs to every other year. In fact, budget cuts had nothing to do with the change to biennual audits. Congress changed the statutory annual audit requirement at the agency's request because the Inspector General of SBA found that 70% of the annual SBIC audits contained no adverse findings and were an inefficient use of his resources.

Your article incorrectly claims that fear of government cuts in funding have discouraged the formation of new SBICs. In fact, Congress has consistently provided adequate funding for the program. The drop in SBIC licensing over the past five years is directly attributable to the Reagan Administration's proposal to close the SBA and terminate the SBIC program. These actions created enormous uncertainty and discouraged potential investors from forming SBICs. With the Bush Administration's support for the program, that trend has now been reversed, with 19 new SBIC licenses issues so far in 1990, an additional 35 license applications pending and a resurgence of interest in the program.

Your article incorrectly cites the Royal Business Funds case as evidence that the program has too few safeguards. In fact, the Royal case had nothing to do with program safeguards or regulations. That case dealt with SBA's management of the company's assets years after it was placed in liquidation.

Finally, your article gives the misleading impression that a recent rash of SBIC defaults have suddenly created a crisis atmosphere in Washington. In fact, we're looking at defaults that evolved over a 10-year period, with the Royal liquidation in 1981 and River Capital in 1989; there is no crisis; and neither Congress nor the Administration is overreacting.

Your article completely neglected the positive side of the SBIC story. SBICs have successfully financed small, high-risk growth companies for over 30 years. The impact of those investments on our economy have been enormous - creating jobs, producing new products and technologies, generating additional tax revenues, enhancing the U.S. competitive position and fostering the entrepreneurial spirit in America. That's the story that should be told.

Your magazine has a powerful influence on American business, and it is truly regretable that your irresponsible article may cause many investors not to invest in SBICs. You have unfairly damaged our industry in the eyes of the business community and Washington policymakers, and in the process you have hurt small business.

Peter F. McNeish, President
National Association of
Small Business Investment Companies
Washington, DC

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August 8, 1990

Honorable Dale Bumpers
Chairman Senate Small Business Committee
SD-229 Dirksen Senate Office Building
Washington, D.C. 20510-0401

Dear Senator Bumpers:

The National Association of Investment Companies (NAIC) was pleased to have the opportunity to appear before the Senate Small Business Committee during its August 2 hearings on the SBIC program. Let me reiterate that our industry shares with you the goal of strengthening the SBIC program.

We had hoped, however, to have the opportunity during the question and answer period to more thoroughly express our concern that minority investment companies are going to be adversely affected as a result of some of the actions being taken to address the subject of the Committee's hearings.

1990 is a very important year in our industry's history. It marks the 20th anniversary of the program. During our first decade, we struggled through the early years to refine our investment policies and develop venture capital expertise.

By the beginning of our second decade, we had developed a base of expertise and the industry was growing at an exceptionally high rate, holding incredible promise for the growth of the minority business community. Unfortunately, just as we were taking off, the Reagan Administration decided to attempt to eliminate our program along with the rest of the SBA. The 1980's, which began with so much promise, ended up being a challenge to our ability to survive.

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But we began our third decade in 1990 with renewed hope, thanks largely to your leadership. In 1989 you spearheaded an initiative which finally ended the industry's years of funding shortages and provided the private sector with a renewed interest in the industry. The Association immediately began to receive requests for information about the program, and the SBA Investment Division has more Specialized SBIC license applications now than it has received during the past several years combined. And, unlike the regular SBIC industry, the number of our Licensees being transferred to portfolio management is at an all-time low.

Unfortunately, we may once again be witness to a potential turning point becoming another setback. The intent of the enabling legislation was to create a high risk venture capital industry. To the extent that this role is diluted or rolled back by SBA, our constituency suffers disproportionally.

As we pointed out in our testimony on August 2, the minority venture capital industry is more important now than it has ever been. In today's environment, banks are becoming increasingly conservative in their lending policies. Blacks in particular have experienced a significant decrease in capital availability, with their portion of SBA 7(a) loans falling from 17.6% when our program was started to its current rate of 2.5%.

We urge you, in your efforts to achieve our shared goal of strengthening the program, to be mindful of the effects some of the actions taken as a result of the hearings may have on minority business development. We are working to minimize any detrimental impact these very important hearings may have on the industry. As part of our efforts, we are meeting with members of the Congressional Black Caucus and the Congressional Hispanic Caucus to make them aware of the situation.

We are hopeful that with their help, and yours, we finally will be able to realize the tremendous potential of the Specialized SBIC industry.

Sincerely,

JoAnn Price

JoAnn H. Price

cc: Honorable Rudy Boschwitz
Honorable Ronald V. Dellums
Honorable E. (Kika) delaGarza